APRIL 2005

1905 100 YEARS 2005

JOURNAL OF ACCOUNTANCY

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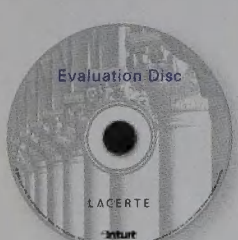

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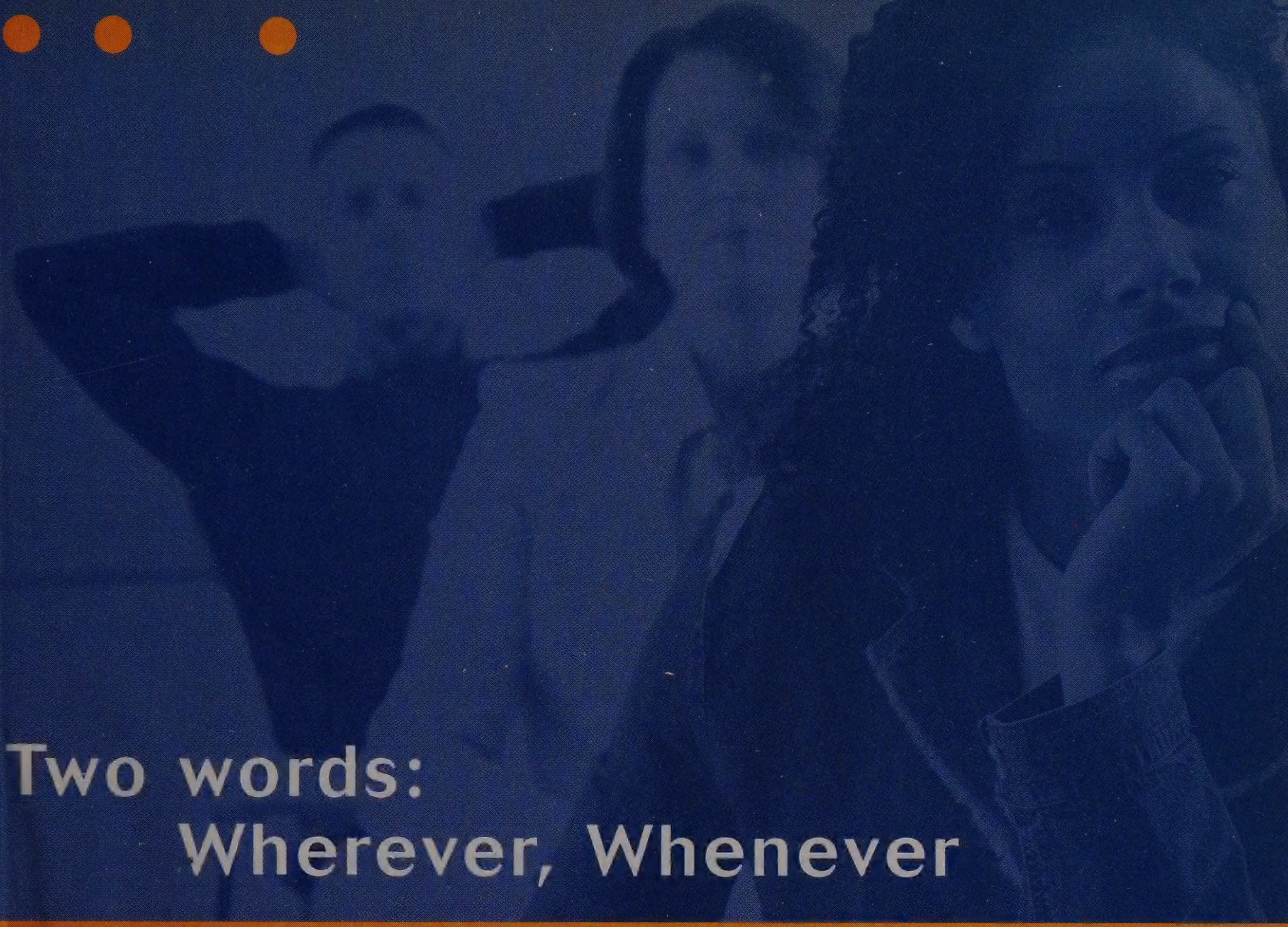
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APRIL 2005 ▪ Volume 199, Number 4

www.aicpa.org/pubs/jofa/joahome.htm

Cover Illustration by Melanie Isaacson/Images.com

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This symbol identifies articles in the home study CPE program.

Advertisers in this issue, page 115.

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AICPA

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Editorial Offices
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e-mail: joaed@aicpa.org

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In This Issue

Highlights

ETHICS INTERPRETATION REVISIONS BASED ON MEMBER FEEDBACK

The AICPA Professional Ethics Executive Committee (PEEC) revised three aspects of Interpretation 101-3, "Performance of Nonattest Services," to respond to members' questions about the intent of the guidance and to ensure its continued effectiveness in promoting members' independence when rendering nonattest services to attest clients (**www.aicpa.org/members/div/ethics/intr_101-3.htm**). The revisions relate to the following general requirements of the interpretation.

Competency requirement. This provides in part that an attest client must designate a competent employee to oversee the provision of nonattest services to that client. Revision: To clarify its intent, PEEC replaced the term *competence* with the phrase *suitable skill, knowledge, and/or experience* throughout the interpretation and substituted for the term (client) *employee* the word *individual* to make it clear that the person the client designates to oversee the service could be the company owner or an external party—such as a bookkeeper or controller, where those functions are outsourced.

Documentation requirement. This requires that members document their understanding of key aspects of the nonattest services engagement with the client. Revision: A member's failure to document an existing understanding with a client will *not* impair his or her independence; however, such a failure will violate Rule 202, Compliance With Standards, of the Code of Professional Conduct.

Routine activities. The revision clarifies that routine activities performed as part of the normal relationship with the client are exempt from both of the above general requirements. To provide further guidance, PEEC will define *routine activities* for the interpretation's purposes.

The AICPA professional ethics staff also revised its bookkeeping and general requirement questions and answers (**www.aicpa.org/download/ethics/nonattest_q_a.pdf**) to address member inquiries and reflect recent changes in the PEEC's independence guidance.

PRIVATE COMPANY GAAP NECESSARY

An AICPA task force unanimously supported developing GAAP for private companies using concepts and accounting that meet the needs of their financial statement users. Privately held, for-profit entities represent more than 99% of the nation's incorporated businesses.

James G. Castellano, CPA, task force head and former AICPA chair, said the group had had no preconceived notion of problems with private company GAAP financial reporting. "We wanted to find out whether those who did have concerns were a vocal minority or a majority of stakeholders," he said. The task force based its conclusions on comments from more than 3,700 lenders, investors, sureties, business owners, financial managers and public accounting practitioners. Its report is available at **www.aicpa.org/members/div/acctstd/pvtco_fincl_reprt/index.htm**.

Although these key constituency groups gave a fairly high rating to GAAP's overall value as exemplified by its consistency and usefulness in making capital allocation decisions, they also said many GAAP requirements should be more relevant to and useful for private company financial reporting.

"We reached out to numerous organizations and individuals at various points in this process," said AICPA President and CEO Barry C. Melancon, CPA. "The AICPA board of directors, subject to input from its governing council, supports the task force's findings and conclusions. A collaborative effort is the best way forward on this important topic."

IFAC AUDIT BOARD NEEDS PUBLIC MEMBERS

The International Federation of Accountants (**www.ifac.org**) is seeking two public members for its International Auditing and Assurance Standards Board and will accept nominations until April 15, 2005. Candidates need not possess a professional accounting designation, but should have significant experience with audit issues related to public and private companies and government entities.

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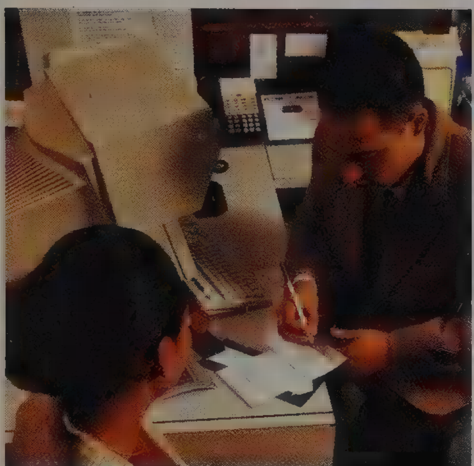

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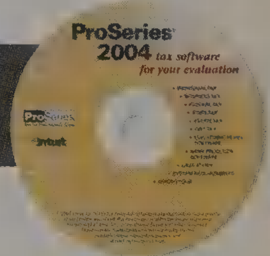

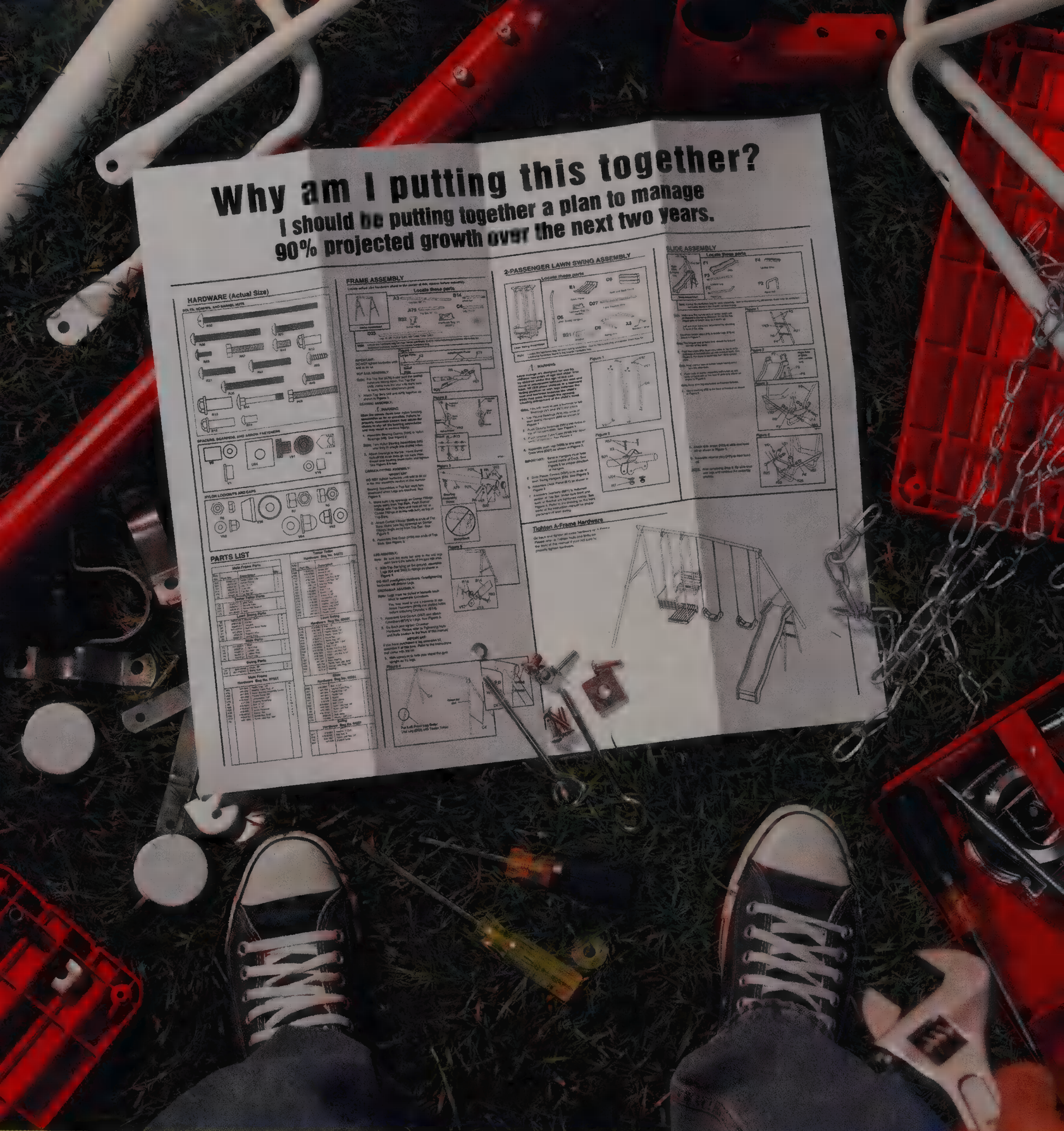

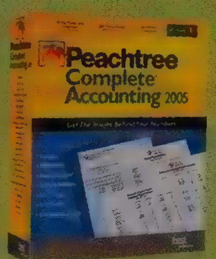

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Letters

Applause for JofA

I applaud your honoring the 100th anniversary of the *JofA* with excerpts from earlier issues. The bottom line in the letter in the January issue (page 11)—"the more things change, the more things stay the same"—is certainly supported by the November 1955 table of contents that ran in February (page 11).

I am sure plans for forthcoming issues are appropriate and will be of much interest to readers. Nonetheless, I would like to make a simple suggestion based on my general impressions from reading/scanning the *JofA* from the November 1905 issue through approximately the mid-70s at the West Virginia University's main library: Ask some key thinkers among practitioners to identify the articles most perceptive in describing/predicting the future among the feature articles for each of the 10 decades of publication. The initial selections could be reviewed by a group of evaluators, and the best of each decade posted at an AICPA Web site or excerpted for the October 2005 issue.

There were many excellent articles that reflected serious interest in furthering the practice of public accounting. A sample of the insight of writers would be appealing! Are some predictions about 2105 a possibility?

Best wishes for much enjoyment of the *JofA*'s 100th anniversary!

Mary Ellen Oliverio, CPA
New York City

First JofA and Today

In a reprint of the first issue of the *JofA* in 1905 (*JofA*, Jan.05, page 12) the first paragraph citing the growth of the profession and the trend toward periodic audits by CPAs noted, "Banks, trust companies and insurance companies have more recently adopted the same plan as a guarantee of security to depositors and policyholders, and the best method of protecting against fraud."

It seems the public expectation in 1905 that audits should protect against fraud existed before most states had passed public accountancy acts. Who has the wrong expectation of audit scope? Is it the public or the profession? Maybe it is time to stop complaining that too much is expected and just find a way to deliver the service.

Joe von Bose, CPA
Corporate Manager of Accounting Operations
Six Flags Theme Parks
Grand Prairie, Texas

Cash Is Best

"Price Equals Value Plus Terms" (*JofA*, Dec.04, page 67) is one of the most comprehensive articles on CPA practice pricing I have ever read. However, the comment, "Low interest rates have encouraged many recent buyers to borrow the money to make a large down payment and thereby reduce the purchase price," defies accepted wisdom.

Those who charge their purchases often pay far more than those using their own cash at closing—and so, too, have many CPAs, plied for decades with bankers' accommodating credit.

James McKeown, CPA
Cicero, New York

Author's reply: I agree wholeheartedly with the writer's point regarding cash up front. The article was citing a trend, not my opinion, regarding this subject. However, your comment is based on the assumption that the buyer has the cash available without the need for an external lender, which is definitely not the case in every situation.

Also, if a buyer can reduce a multiple to, let's say, 0.75X instead of 1X with additional cash, that may be a greater savings than the interest factor.

Joel Sinkin
J. Sinkin Consulting
Happauge, New York

What were the profession's contributions during the Second World War? Two *Journal of Accountancy* editorials—one from October 1939, before the United States entered into combat, and one from June 1945, written just as V-E day was announced—describe the contribution CPAs made during the war years and envision the many areas in which they would be needed in an economy shaken by battle. We reprint these glimpses into the profession's past as part of an ongoing series celebrating the *JofA*'s centennial this year.

1905 100 YEARS 2005

Looking Back

THE JOURNAL IN WORLD WAR II

"Inevitable speculation as to whether the United States will become involved in the conflict will remind many accountants of the demands on them in 1917 and 1918. Supervision of accounting related to cantonment construction; cooperation with government departments in scrutinizing contracts for supplies; service with government boards for review of excess-profits taxes, for price fixing, for property accountability, and for review of interallied transactions are some of the activities which will be remembered.

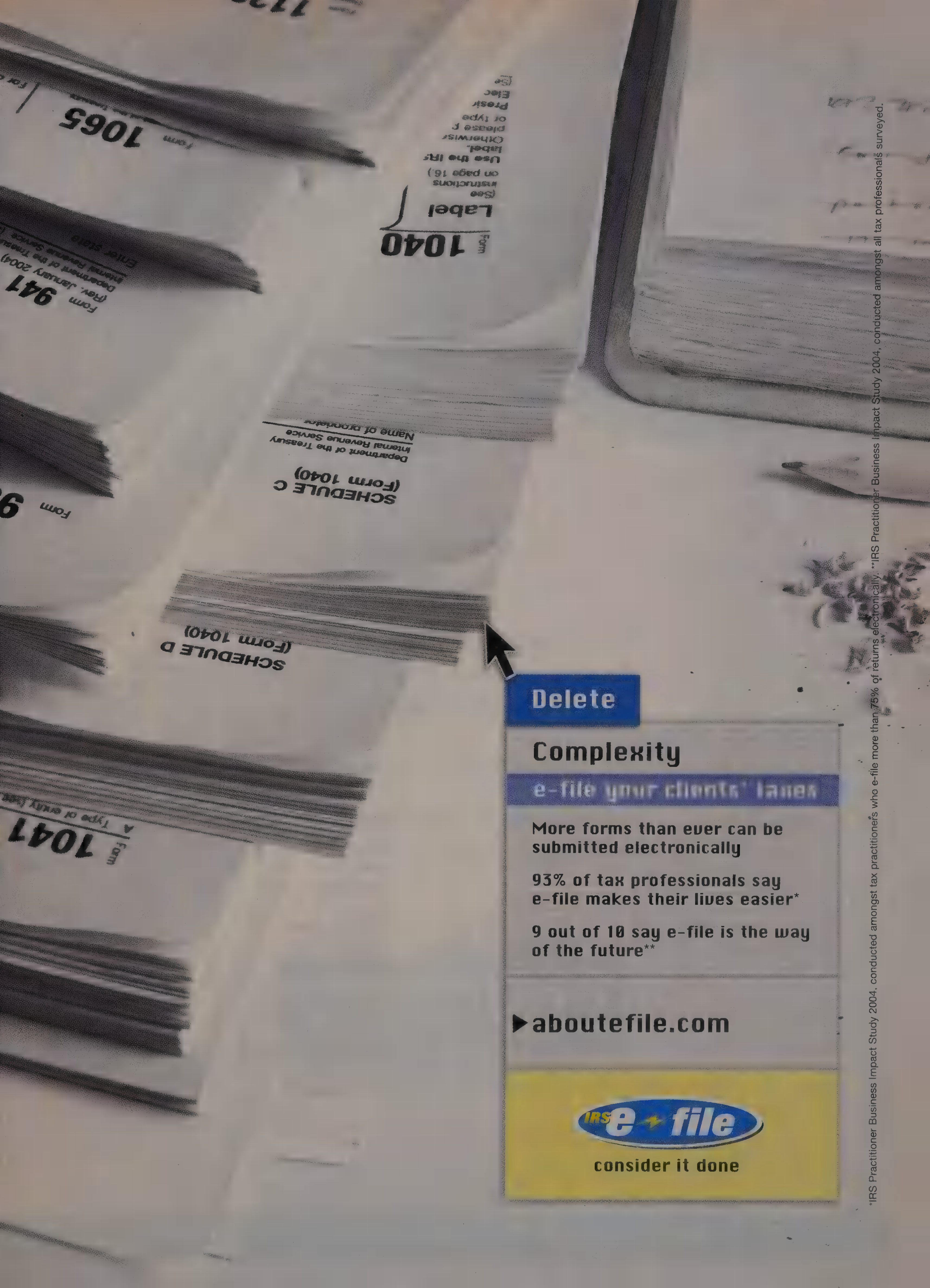
The accounting profession proved its mettle then, and if the call comes it will serve again."
—*October 1939*

"Accountants played their part in bringing about [the war's] successful conclusion. In uniform and out, they did what was required of them to keep in working order the complex network of financial transactions, which might be described as the nervous system of a free-enterprise economy engaged in total war.

Without the accounting profession's aid the intricate procedures for procurement of war material, price control, war taxation, renegotiation and termination of war contracts would hardly have been possible; nor could the civilian economy have kept from bogging down in the maze of record-keeping and reporting requirements imposed upon it. The profit system might have had to be suspended for the duration; or exploitation of the war emergency might have been wide enough to earn the lasting enmity of all the people for private business.

The second half of the double war [*Editor's note: The writer refers to the war in Asia, which had not yet ended*] remains to be won, and accountants will continue to do their part in winning it. But it is reasonable to suppose that problems of a different nature will soon confront the profession—problems related to surplus-property disposal, reconversion, expansion, new financing, international trade, and government regulation designed to improve the living standards of the people, rather than to fight a war. Accountants will have great opportunities to help their clients and the whole public in the solution of these problems. Their training and experience—particularly in the rigorous experience of the war years—equip them admirably to take a leading part in the rebuilding of a peaceful economy."
—*June 1945*

TYPOGRAPHIC ILLUSTRATION BY DANIEL PELAVIN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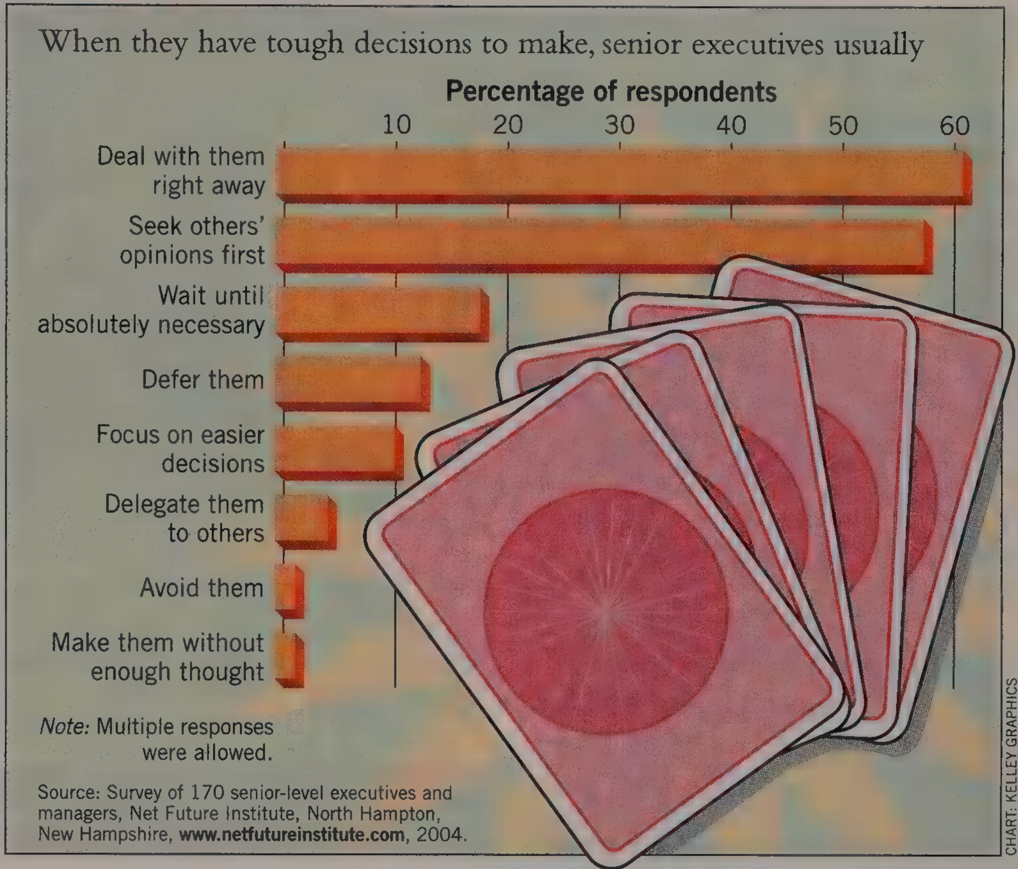
NEWS DIGEST

Know When to Hold 'Em



Source: Survey of 170 senior-level executives and managers, Net Future Institute, North Hampton, New Hampshire, **www.netfutureinstitute.com**, 2004.

AUDITING

■ The AICPA enhanced the Web site (**www.aicpa.org/EBPAQC**) of its Employee Benefit Plan Audit Quality Center, a firm-based voluntary membership community promoting high-quality audits of pension, health and welfare and 401(k) plans. The center offers practical tools, guidance on audit performance, best practices and information on emerging issues to auditors interested in or practicing in this area. It also raises public awareness of members' commitment to maximizing audit quality. The Institute organized the Web site around a home page that serves as a single access point to the latest developments in employee benefit plan audits.

■ The Public Company Accounting Oversight Board (PCAOB) issued a question and answer (Q&A) on implementing Auditing Standard no. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, supplementing those it published in 2004 (**www.pcaobus.org/standards/staff_questions_and_answers/index.asp**). The Q&A provides guidance on the documentation completion date. Concurrently the Securities and Exchange Commission's (SEC) Division of Corporation Finance released a series of Q&As representing the SEC staff's views on exemptions from commission rules on the filing of management's report on internal control over financial reporting and the related auditor report (**www.sec.gov/divisions/corpfin/faq012105.htm**).

■ The AICPA published a collection of all PCAOB professional standards and associated rulings through December 1, 2004. The paperback *PCAOB Standards and Related Rules* (# 057195JA) can be ordered online at **www.cpa2biz.com** or by phone at 888-777-7077 (members, $84; nonmembers, $105).

FINANCIAL REPORTING

■ Financial Executives International CEO and President Colleen Cunningham identified the following topics (**www.fei.org/fei_ceo_top10.cfm**) as 2005's top 10 financial reporting challenges: accounting for stock options, internal controls reporting, revenue recognition, uncertain tax positions in financial statements, repatriation of foreign earnings, accounting for business combinations, accounting for inventory costs, disclosure of off-balance-sheet arrangements, adoption of the extensible business reporting language and SEC guidance on management discussion and analysis.

■ The SEC established a voluntary program under which registrants may submit certain mandatory filings to the commission (**www.sec.gov/spotlight/xbrl.htm**) in extensible business reporting language (XBRL) format. The program, which begins with the 2004 calendar yearend reporting season, will assess registrants' ability to properly tag their data in XBRL and the benefits of using tagged data for analysis. (For

■ For single-click access to further coverage of the news stories listed here, visit the *Journal of Accountancy* Web site at **www.aicpa.org/pubs/jofa/joahome.htm**.

■ For news from the AICPA and state societies, visit **www.cpa2biz.com**, which also offers online CPE, AICPA professional literature, practice management aids and links to state society Web sites.

more on XBRL, see "XBRL: A Multitalented Tool," page 70.)

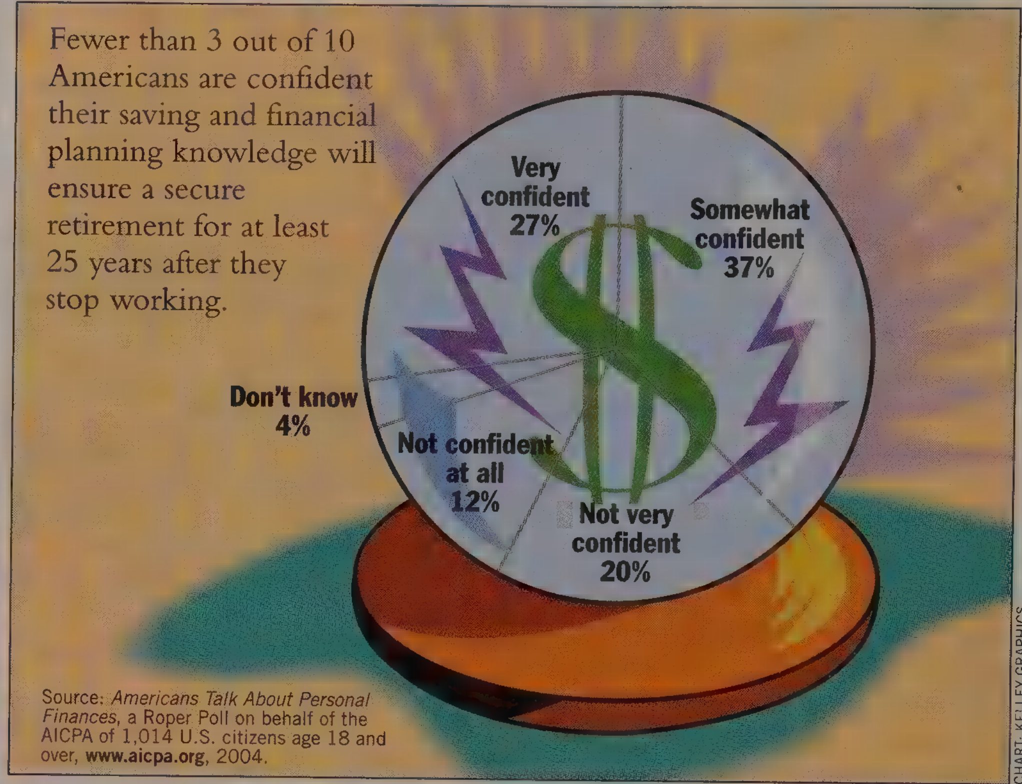
GOVERNMENT ACCOUNTING

The Federal Accounting Standards Advisory Board (FASAB) issued immediately effective implementation guidance for Statement of Federal Financial Accounting Standards (SFFAS) 23, *Eliminating the Category National Defense Property, Plant, and Equipment* (**www.fasab.gov/pdffiles/sig_23_1.pdf**).

INTERNATIONAL

The International Federation of Accountants (IFAC) released an exposure draft (ED) and several publications. The ED, *Proposed International Public Sector Accounting Standard: Financial Reporting Under the Cash Basis of Accounting—Disclosure Requirements for Recipients of External Assistance*, is intended to enhance transparency and relevance of disclosures about financial assistance to governments and other public sector entities. Comments are due June 15, 2005. IFAC also published a report, *International Public Sector Accounting Standards (IPSASs) and Statistical Bases of Financial Reporting: An Analysis of Differences and Recommendations for Convergence*, and released the 2005 editions of *Handbook of International Auditing, Assurance, and Ethics Pronouncements* and *Handbook of International Public Sector Accounting Pronouncements*. They're available at **www.ifac.org/store**.

Your Financial Future



Source: *Americans Talk About Personal Finances*, a Roper Poll on behalf of the AICPA of 1,014 U.S. citizens age 18 and over, **www.aicpa.org**, 2004.

INVESTMENT RESEARCH

A joint task force of the Institute of Chartered Financial Analysts and the National Investor Relations Institute released as final voluntary best practice guidelines governing relations between securities analysts and companies they cover (**www.cfainstitute.org**). They address analysts' independence from corporate issuers' influence, analysts' access to issuer executives, disputes between companies and analysts over published reports, corporate issuers' prepublication review of analysts' reports, and issuer-sponsored research.

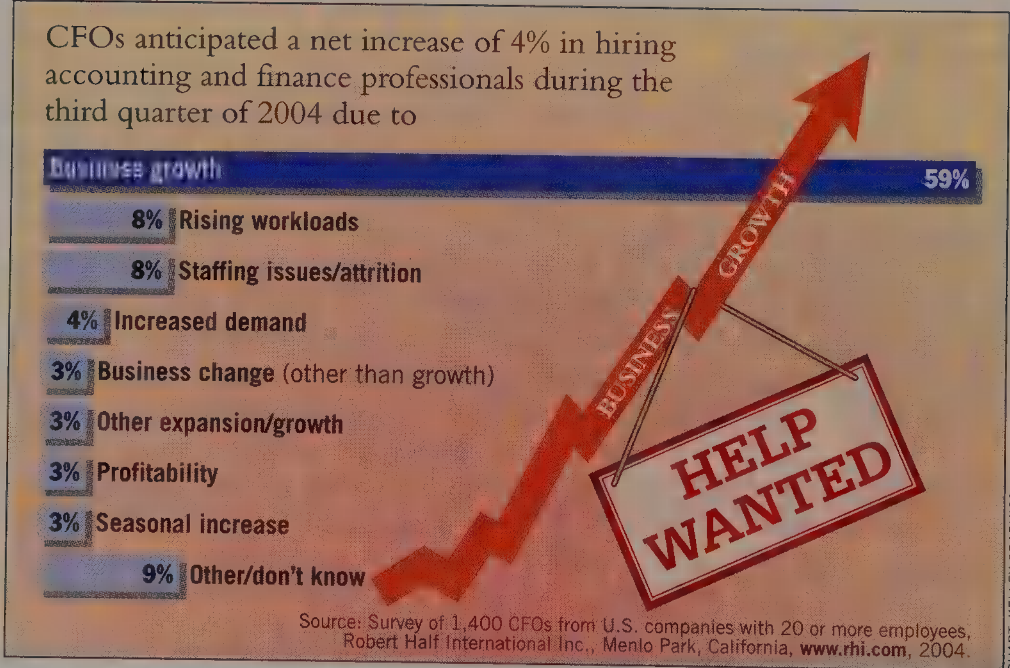
PERSONAL FINANCIAL PLANNING

The AICPA and the Department of Labor (DOL) are partnering to educate American women of all ages about personal financial management. Using CPA/PFS (Personal Financial Specialist) volunteers from the Institute's 360 Degrees of Financial Literacy program (**www.aicpa.org/financialliteracy/index.asp**) and the resources of the DOL Women's Bureau (**www.dol.gov/wb**), such as mentoring, classroom instruction and an online financial education curriculum, the partnership will help women develop the practical skills they need to better control their money and lives.

PROFESSIONAL ISSUES

The AICPA released the 2004 edition of its annual report, *The Supply of*

Growth Drives Hiring



Source: Survey of 1,400 CFOs from U.S. companies with 20 or more employees, Robert Half International Inc., Menlo Park, California, **www.rhi.com**, 2004.

Accounting Graduates and the Demand for Public Accounting Recruits (**www.aicpa.org/members/div/career/edu/sagdpar.htm**), which found the number of bachelor's degrees awarded rose by 6% and master's degrees by 30% over the prior year while enrollment in accounting programs grew by roughly the same percentages. More than 109,000 candidates sat for the CPA examination—slightly more than in 2003. Hiring increased at single-digit rates and 18% of new employees were members of minority groups. The report predicted long-term growth in hiring of accounting graduates by firms of all sizes.

FYI

■ The AICPA named Ben Neuhausen of BDO Seidman LLP the chair of its Accounting Standards Executive Committee (AcSEC), succeeding Mark Bielstein of KPMG LLP. As an AcSEC member, Neuhausen earlier chaired the AICPA Task Force on Real-Estate Time-Share Transactions. AcSEC member Carl Kampel of Ellin & Tucker, Chartered, will become the committee's vice-chair after its meeting this month.

■ An AICPA Business and Industry Economic Outlook Survey (**www.aicpa.org/download/cefm/business_industry_survey.pdf**) found that 71% of CPAs serving as CEOs or CFOs were optimistic about the nation's economy and its prospects this year.

■ The AICPA developed an incident response plan (**www.aicpa.org/innovation/baas/ewp/incident_response_plan.asp**) that CPAs can use to help organizations design, create or adapt customized strategies for managing security breaches that threaten the confidentiality of individuals' personal information.

■ The U.S. Department of Commerce's International Trade Administration is seeking CPAs with two or more years of public accounting experience to perform cost-of-production investigations of foreign manufacturers. The starting salary ranges from $62,886 to $81,747. Applicants must be U.S. citizens and proficient in GAAP, GAAS and manufacturers' cost-accounting systems. E-mail resumes to accounting_office@ita.doc.gov.

■ The IRS developed the EITC Assistant, a Web-based questionnaire designed to help working families determine whether they're eligible for the earned income tax credit (EITC) and, if so, to estimate how much credit they'll receive (**www.irs.gov/irs/article/0,,id=134523,00.html**). For 2004 the maximum credit is $4,300. The tool is available in English and Spanish and reflects recent tax law changes, including new income limits for eligibility. ■

AICPA

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NEW IN THE STORE

Buying or Selling, CPAs Must Know the Details

Here's how to make the right tax choices in the purchase or sale of a business.

by William H. Olson, Ph.D., CPA

In making an acquisition or disposition of a corporate business, a thorough analysis is necessary to adequately advise clients and senior company management.

Taxpayers selling a business must ensure that all tax, accounting, and operational considerations have been addressed. The seller should attempt to foresee what items and business areas would be important to a potential buyer. For example, the buyer of a corporate business relies greatly on the seller's financial statements.

To a large extent the sale price is determined on the historical information found in these financial statements. If the seller's financial statements have never been audited, or have not been audited within the past six months, an audit should be considered to allow for an accurate presentation of current financial information.

Some other items that may be important:

- The payment record of federal taxes
- State income tax
- Sales tax
- Franchise tax
- Stamp and transfer taxes
- Contractual obligations
- Title restrictions on property
- Registration of patents; trademarks; trade names and copyrights

From the buyer's standpoint, appropriate "due diligence" procedures must be performed to ensure that the transaction is structured properly, the purchase price is not overstated, and all potential liabilities have been identified.

From a tax perspective two considerations are of paramount importance: Should the transaction be structured as a sale of *stock* or *assets*? And, should the transaction be structured as a *taxable* or *tax-free* acquisition?

For the *buyer* of a business an acquisition of assets is generally preferable to the acquisition of stock. For example, an asset acquisition allows the buyer to purchase specific assets of the corporation. The segregation of specific assets with a stock sale is difficult.

The buyer can also "step-up" the tax basis of the assets in an asset purchase to increase depreciation deductions. Furthermore, an asset acquisition allows the buyer to purchase the assets without regard to contingent or unknown liabilities.

For the *seller* of a business, a *stock* sale is generally preferable to an asset sale. A stock sale is generally a simpler transaction to consummate. The sale of stock by the shareholders generally results in a capital gain, while the sale of assets by the corporation can result in significant ordinary income. Furthermore, unlike a stock sale, an asset sale triggers both a corporate level tax and a shareholder level tax.

Olson is a Principal with UHY Mann Frankfort Stein and Lipp Advisors Inc., Houston. This is adapted from "Tax Consequences of the Purchase and Sale of a Business."

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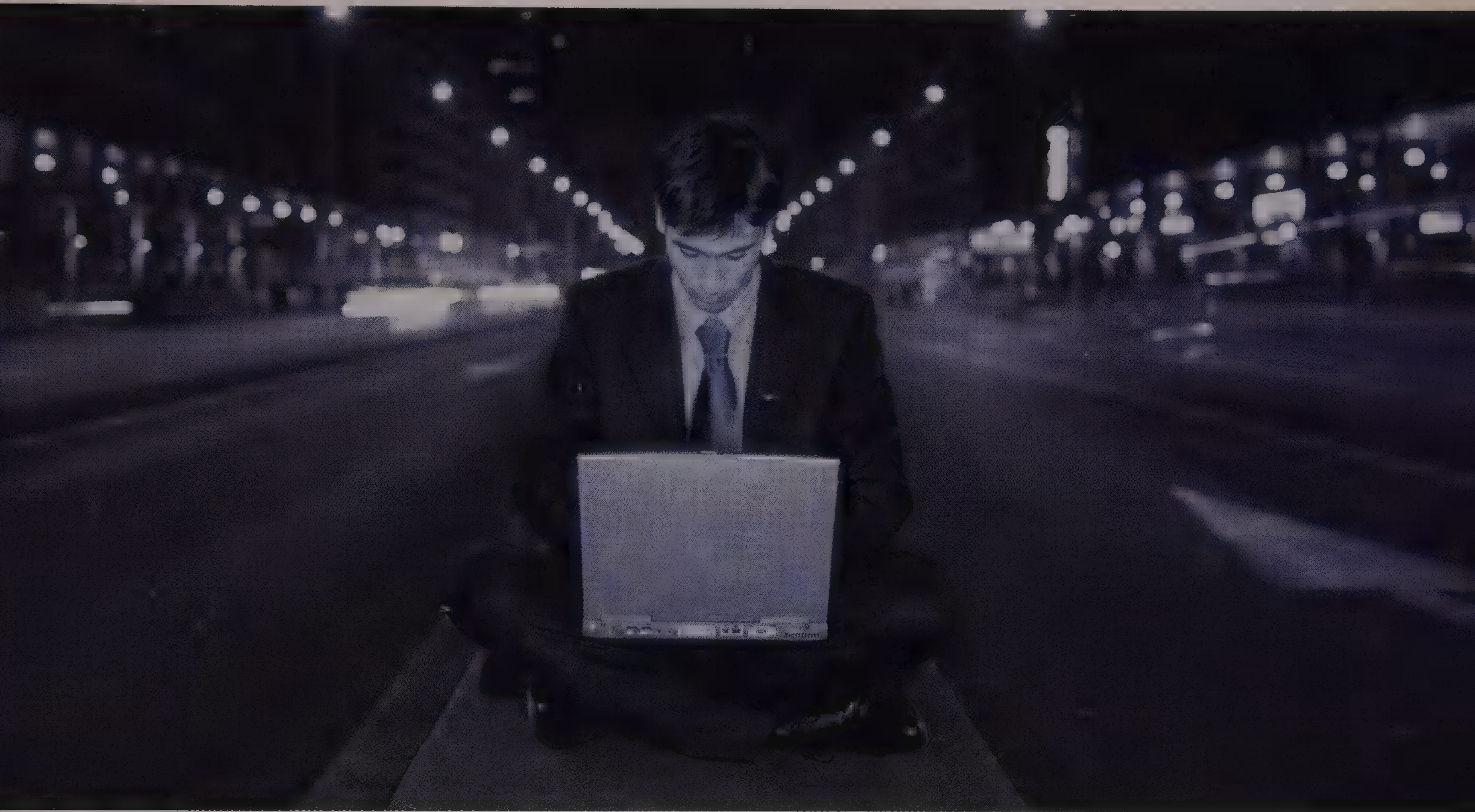

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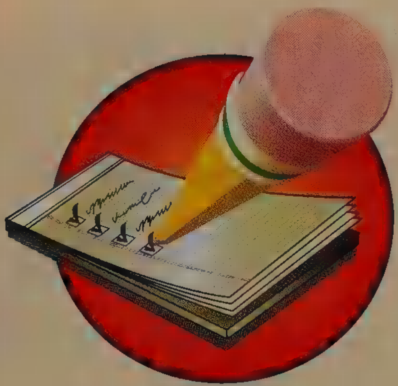
MONTHLY CHECKLIST SERIES

Hit Your Target With Effective Marketing



Financial advisers can build up their practices by clearly identifying the clients they want and targeting their marketing campaigns to reach them. Here are some points to keep in mind.

- ❑ ***Identify your target market in detail.*** A clear focus produces the best results. It's easier and less expensive to reach a well-thought-out target, such as workers trying to save for retirement while paying for their children's college education and parents' nursing home care, than it is to pursue an overly broad group, such as those between 50 and 70 years of age with more than $250,000 in investable assets.

- ❑ ***Know your target.*** Focus less attention on age, income, gender and other impersonal characteristics, and more on personal interests and concerns, such as funding for a secure retirement, business succession and estate planning.

- ❑ ***Tailor your message.*** Provide key customers information on how you will address their interests and concerns and help achieve their financial goals.

- ❑ ***Watch reactions closely.*** Track the pieces of your marketing literature that stimulate the greatest interest among your target market and hone your materials to increase response rates.

- ❑ ***Use new technology to speed testing.*** It no longer takes months to find out how well a marketing plan design works. Technology makes it possible to simultaneously test up to seven variables, such as headline wording, offering terms or type face and quickly determine the combination to which the target market will best respond. Incorporate those elements in your marketing materials.

Editor's note: The AICPA offers a free CPA Marketing Tool Kit to help members promote their practices and services. To learn more, visit **www.aicpa.org/cpamarketing**.

Source: Advisor Marketing, **www.advisormarketing.com**, 2005.

SMART STOPS ON THE WEB

WEALTH MANAGEMENT SITES

Keep Tabs on Their Money
www.carsonwealth.com

The Carson Wealth Management Group Web site's Research section offers CPA investment advisers news headlines and market summaries from Dow Jones, the Nasdaq and Standard and Poor's—with the latest index figures and most recent changes, a stock quote center and a mutual fund lookup. This Smart Stop also has links to calculators for insurance, retirement planning, savings and tax estimators.

Teaching the Teacher
www.meridianwealth.com

Certified financial planner Scott Dauenhauer's site educates educators about retirement planning under IRC section 403(b) with articles such as "Your Best Interest or Your District's?" and "Choosing a Good Financial Adviser." Users can read current and archived issues of *The Teachers Advocate* e-newsletter, find links to financial calculators and read information about long-term care. The site also includes a link to another Dauenhauer e-stop, **www.403bretire.com**, with discussion boards and FAQs.

News, Clues and Views
www.wealthmgt.com

Financial advisers can find resources for clients here. In addition to headline links to stock market news, this stop has business, U.S. and international news. In the Investor Center visitors can find links to sites on estate and retirement planning, mutual funds and taxes, as well as calculators that show the dollars-and-cents cost of postponing a savings plan. The page has a link to current and archived installments of the site's weekly market commentary.

Plan Tomorrow Today
www.stephens.com

Investment bank Stephens Inc. offers financial planners wealth management tools in the Private Client Group section, including guides on education and estate planning—with information on establishing revocable living or irrevocable trusts—and investing for retirement. Also, use the calculators to check bond yields, college costs or cash value and income gap at retirement.

Rich in Resources
www.wealthmgmt.com

This Web spot has free resources for unregistered users in its Planning section including "Do I Need a Financial Plan?" and a flowchart of the process. Current articles, such as "Alternative Investment Lingo" and archived ones, including "Responding to a Volatile Market" and "Value of Diversification," are available from Wealth Management LLC's monthly publication *Wealthy Minute*. Users also get free access to the site's financial calculators on asset allocation, investments, loans, mortgages and taxes.

GENERAL INTEREST SITES

Grow or No Go?
www.annuitiesnet.com

CPA broker-dealers can check on variable annuity rates or find annuity sponsors and links for state insurance and securities regulatory departments here. Users can find links to industry articles and newsletters in the News section, browse a calendar of conferences or search for jobs in Tools, which also has links to airlines and airports, phone directories, travel agencies and weather services.

Compliance for Dummies
www.soxlaw.com

This e-guide gives a basic overview of the Sarbanes-Oxley Act of 2002 and summarizes its five sections dealing with compliance issues, including section 302 on financial reporting and section 401 on financial statements. Other topics include disclosure, fraud and internal controls. Click the link to **www.aicpa.org** to read a humorous section on how *not* to spell Sarbanes and Oxley.

Technology for the Little Guy
www.smallbusinesscomputing.com

CPAs who double as IT advisers and small firm owners looking for technology guidance will find it here with links to news articles such as "Automate Your Business Processes" and "Prevent Data Disasters in 2005." Other resources include a buyer's guide and special reports in the Small Business Essentials section. Users also can join discussion forums on e-commerce and online marketing, or read a glossary of the top 40 small business computing terms.

Resources at the Ready
www.refdesk.com

Visitors should bookmark this site for one-click access to business, local and international news, e-dictionaries, encyclopedias and thesauruses, government listings and telephone books. Other links let users search America's Job Bank, check e-mail remotely, get stock quotes and use online calculators and currency converters. Take a break with Daily Diversions and find links to comics, crosswords, the latest Gallup polls, and even David Letterman's recent and past Top 10 lists.

Roth Resources
www.rothira.com

Financial planners will find current and archived news articles such as "Roth IRA Conversion Considerations" here. Visitors can read up on evaluating Roth IRA software or get the full text of the IRS' final regulations, access planning calculators for asset allocation and retirement, get links to related sites and join a discussion board.

An interview with Mark W. Everson, Commissioner of Internal Revenue.

With Integrity and Fairness

Think you're busy this month? Imagine being Mark W. Everson, Commissioner of Internal Revenue, heading into tax season with a $10 billion budget and a staff of 100,000 to manage. Appointed by President Bush in 2003, Everson is a man on a mission. He's almost halfway through his five-year term—and determined to deliver on his charge to reorganize and modernize the nation's tax administration agency without sacrificing its goal: to serve the American public "with integrity and fairness for all." But even as tax season revved into high gear, he took some time in March to talk with the *JofA*'s Geoff Pickard about his personal priorities, his enforcement efforts and his high hopes for closer relationships between his fellow CPAs and the IRS.

"We need to simplify the tax code," acknowledges IRS Commissioner Mark W. Everson, CPA, but changes must improve public attitudes toward compliance and be easy to administer.

JofA: *What do you consider your major accomplishments since taking office two years ago?*

Everson: As I came through the confirmation process, and even in the initial months, Congress, the public and business community people felt that *enforcement* was a dirty word. I think we're beyond that now; there's a recognition that the IRS needs to provide service but also enforce the law. Enforcement has to be done correctly, of course—evenhandedly, fairly, with respect for taxpayer rights. There has to be a balance.

We say, "Service plus enforcement equals compliance." The big change in the past couple of years is that it's now understood and appreciated as an appropriate approach for tax administration. We have started to bring enforcement back.

JofA: *How would you compare your overall policy direction with that of previous commissioners?*

Everson: I'm the second IRS commissioner to come in under the Reform Act of 1998, which established a five-year term for the commissioner and a new model that saw the executive as a leader of this sprawling organization of 100,000 employees, with lots of different responsibilities.

It's difficult to compare what Charles Rossotti and I faced with the previous model, where typically the commissioner was a tax practitioner and not a manager.

When Charles came in there was concern about the services the IRS was providing—or, more correctly stated, failing

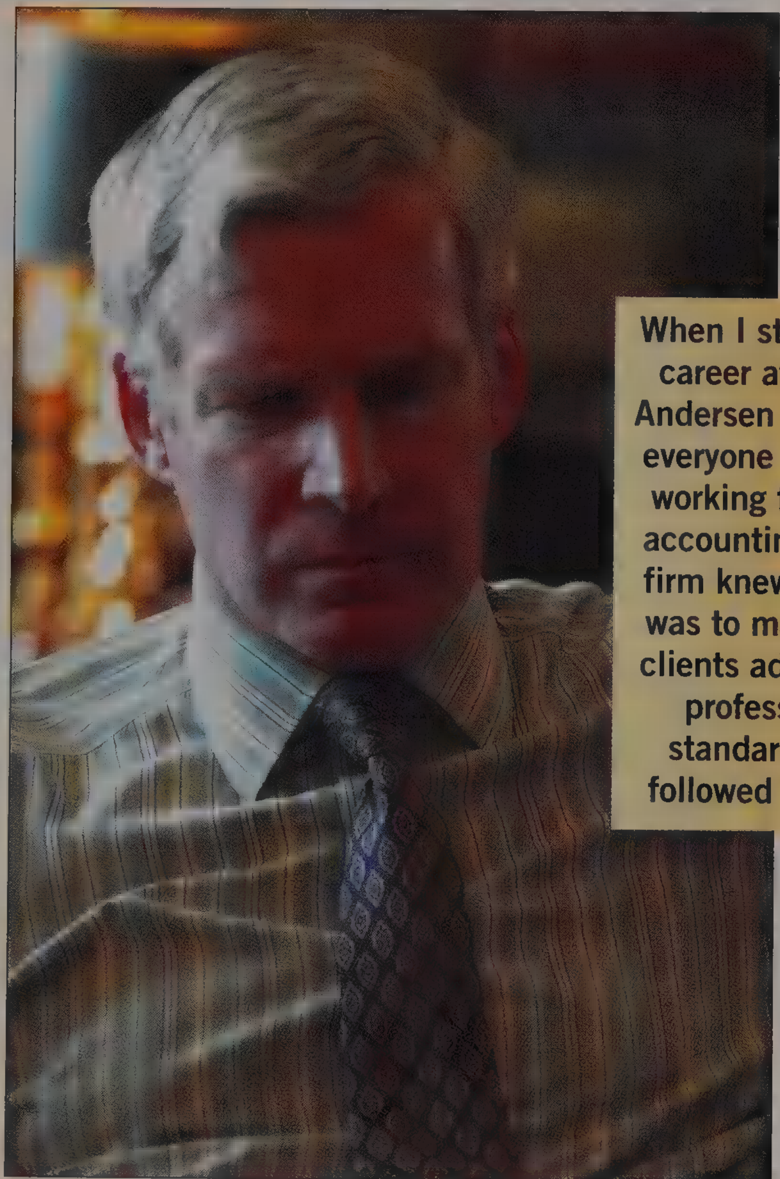
to provide—to the public. He worked to improve services, to reorganize the IRS around taxpayer segments and to make the service more transparent and efficient. I think he achieved that goal. There's no doubt the IRS made a lot of progress.

But for a variety of reasons the enforcement side did languish; the presence receded. We've improved the services, and now the principal work here is to rebalance the agency.

We have three strategic priorities: to continue to improve service, to enhance enforcement and to modernize the agency. The first two are operational objectives, but in order to make them work you have to spend a lot of time on the third. Charles launched a lot of very important actions in that area that we're building on.

JofA: *How do the enforcement statistics from recent years weigh on policy?*

Everson: Clearly, there has been erosion over a long period—through the 1990s to about 2000—in the number of audits and criminal investigations. The IRS did a lot less enforcement at just the wrong time, just when corporate governance was going off track, when a culture of greed seemed to take hold. Mix that with a sad and precipitous erosion in the accounting and legal professions and it made for a bad cocktail.



When I started my career at Arthur Andersen in 1976, everyone who was working for a big accounting or law firm knew the job was to make sure clients adhered to professional standards and followed the law.

Over the past two years in particular we've been rebuilding enforcement. In the fiscal year that ended in September, we surpassed a million audits of individuals for the first time in four years. And we've started to bring back corporate audits, after years of decline. Last year our audits, document matching and collection activities resulted in our collecting $43.1 billion in direct revenues—up more than 15% from the year before. And that number doesn't include the incremental positive effect on compliance. If we audit Joe, even if we don't collect any additional revenues, Joe tells his friends, and maybe someone who was thinking about playing it a little fast and loose changes his mind because of the audit Joe went through. That, too, means real money coming in.

These things are starting to trend up. The president has asked for more money for enforcement activities. In a time where deficit reduction is an important priority for the country, the IRS is the only government agency that can make a direct contribution in that way.

JofA: *What specific compliance areas is the IRS targeting?*

Everson: We've established four enforcement priorities, and they're mutually reinforcing. One is to detect and deter noncompliance, particularly among high-income individuals and corporations. Audits of high-income taxpayers—those earning $100,000 or more—topped 195,000. That's a 40% increase from 2003. Second is to assure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law. Third is to augment our criminal investigations to increase the number of tax cases we bring, and also to support other government activities, investigating corporate fraud, narcotics and terrorism. The fourth is a particularly noteworthy one: to deter abuses within charitable and governmental entities and their misuse for tax-avoidance purposes.

Those four are the underpinnings of our strategic plan. They all come together in the abuse of tax shelters by high-income individuals and corporations to get out of paying their fair share.

JofA: *President Bush has proposed a $500 million increase in the IRS enforcement budget line for 2006. If you get the money, what will you use it for?*

Everson: We'll use it to strengthen our work in those four enforcement priorities. We'll add revenue agents to do audits, revenue officers to collect monies due and criminal investigators. We do a good job of covering very large corporations, but we think we can significantly increase coverage right now of corporations with assets of $10 million to $250 million. We need to improve coverage of exempt organizations. It's not as if we'll just pick any one thing. We need to run a balanced enforcement program.

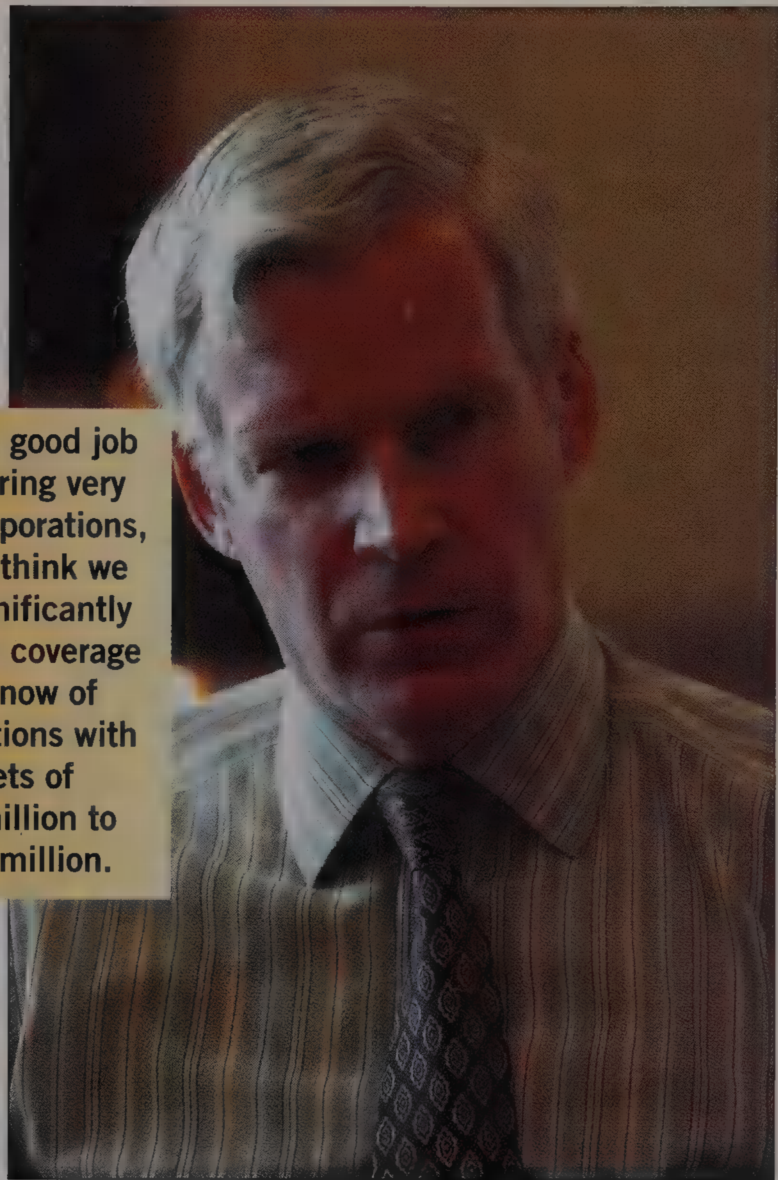
JofA: *Will the average taxpayer see any benefit in customer service from the additional funds?*

Everson: There have been some very dramatic improvements for practitioners on the service side, particularly elec-

tronic employer identification numbers and transcripts that practitioners can access electronically. Probably the most important is the electronic filing of returns, which now is commonplace. This filing season we expect more than half of all individual returns to be filed electronically. That's better for the taxpayer and for the government. Most people still get refunds, and they end up getting a check in just half the time if they file electronically.

But we are tightening our belt to some degree in the customer service area. The deficit pressures are such that the president and the Office of Management and Budget have asked us to manage as efficiently as we can.

We do a good job of covering very large corporations, but we think we can significantly increase coverage right now of corporations with assets of $10 million to $250 million.



JofA: *We've touched on the subject of abusive tax shelters; they've been front-page news for months. How are you dealing with this crisis?*

Everson: The government is doing things on a number of fronts. I commend Congress for passing the American Jobs Creation Act signed in October 2004, which put in stiff penalties for those who fail to comply with some registration and list-maintenance requirements. That was a very strong set of actions.

The act also strengthened our Office of Professional Responsibility [OPR], the historically small and somewhat backwater group charged with getting after those who are noncompliant. I want to emphasize that we think the vast majority of tax attorneys and accountants discharge their duties appropriately. But they've suffered because of the outrageous activities of a limited number of people. We've been doing more in the way of guidance, listing transactions, increasing audits in this area. We have more criminal investigations under way and have recommended more than 3,000 prosecutions, a nearly 20% jump. A big piece of this involves financial crimes, including money laundering and other white-collar crimes, where we work cooperatively with the Department of Justice.

I believe the combination of our activities, the changes in the statute, the congressional climate, the overall changes brought by Sarbanes-Oxley and the responsibility of audit committees is changing the environment. And it's not only the government that's going after the promoters of these products; it's also the marketplace. There have been a lot of civil suits by investors.

JofA: *I know you're keen on professional standards for tax professionals, the Circular 230 change. Can you elaborate a little?*

Everson: I started my career on the audit side at Arthur Andersen in 1976, and at that time everyone who was working for a big accounting or law firm knew the job was to make sure clients adhered to professional standards and followed the law. Then, if you could, you tried to distinguish your firm from its competition on the basis of service.

This all mutated over the next couple of decades to a search for higher compensation for accountants and attorneys based on value creation and risk management. So the model moved, to the detriment of the professions and of our markets.

Circular 230 is an important piece of trying to bring things back to a more evenhanded situation and strengthening the Office of Professional Responsibility. We brought in a tough, no-nonsense former prosecutor as director of OPR—Cono Namorato, whose criminal tax expertise is very well respected. OPR investigates allegations of misconduct or negligence against tax practitioners and enforces the standards of practice for those who represent taxpayers before the IRS, as detailed in Circular 230. The office also licenses "enrolled agents," who are tax professionals meeting certain testing or experience requirements.

The Justice Department is giving us great support on this and sustained us in a number of privilege cases, where privilege had been asserted but was found not to be appropriate. Basically, I think this is a particularly important area for us, and an area where we haven't been strong enough.

JofA: *How will this affect practitioners?*

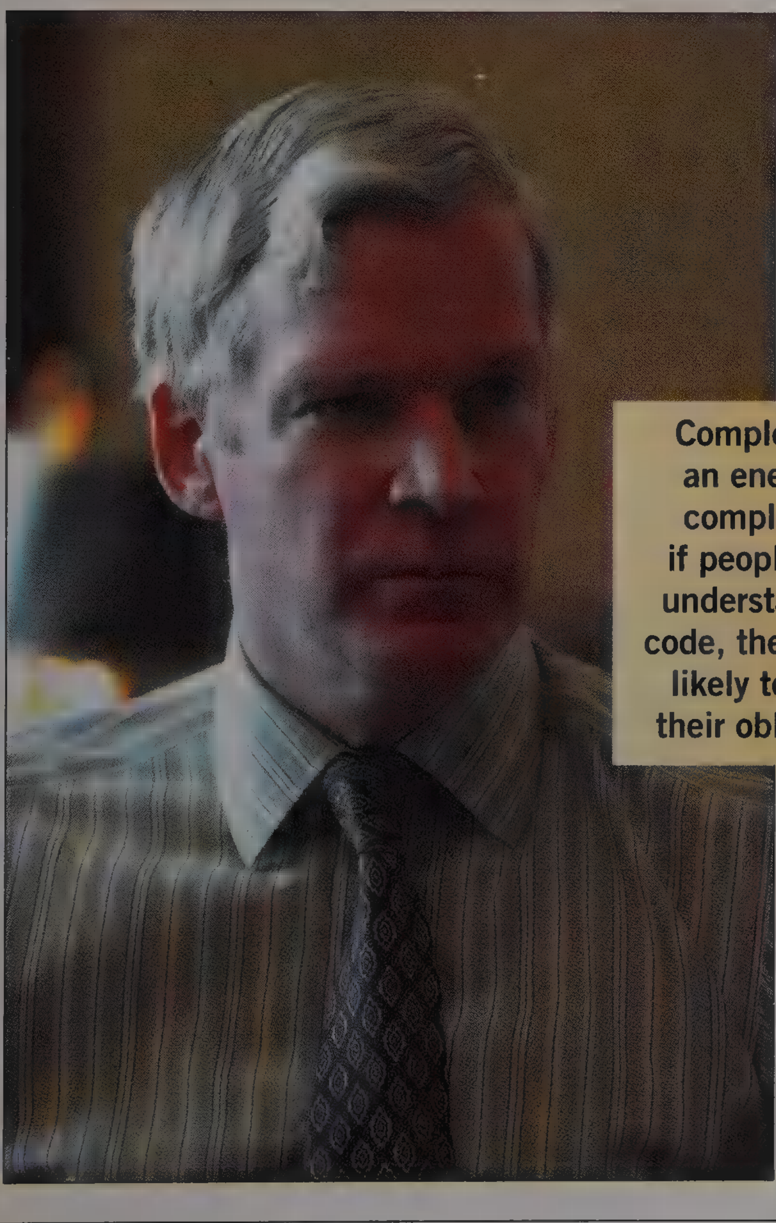
Everson: I think the practitioner community is happy with this initiative, because many good, solid practitioners suffered because of the activities of the few. They had customers saying, "Why should I stick with you, when I could

go down the street and end up paying no tax, or paying half the tax?" Most of the people I talk to may have some areas of concern regarding 230, but by and large, they think these are good, sound measures that need to be taken to restore the integrity of the profession.

JofA: *The AICPA has partnered with the IRS on ethics training seminars. How do you view this initiative?*
Everson: We very much appreciate the dialogue we have with the AICPA and the American Bar Association. We can't administer a tax system alone. We rely on the work of accountants and attorneys to make sure people get good advice and take proper positions.

We want taxpayers to pay what they owe and no more. So having the AICPA communicate what your members feel is important is a key dialogue for us. We try to meet regularly and understand what the emerging issues and concerns are, and where we can do better.

JofA: *What do you see as the role of the CPA in our voluntary tax system?*
Everson: The CPA plays a very important role. Individual and business taxpayers rely on their CPAs to give them answers that are correct under the law without causing them to pay more than they have to. It's a very delicate balance, and one that requires integrity. The tax code is too complex for most people to sort out for themselves.



Complexity is an enemy of compliance; if people can't understand the code, they're less likely to fulfill their obligation.

JofA: *In what areas can the accounting profession best work with the IRS to help achieve better tax compliance?*
Everson: I wouldn't suggest there's any one area, but rather a range of activities. We need feedback on the services we provide, on proposed regulations, on our procedures. Everything we do affects the accounting and tax professions, and accountants and attorneys are part of every process. So it's not in any way limited to one conversation.

I would like to have a continuing dialogue about compliance and where you see changes in attitudes or emerging problems. You can help us stay ahead of the curve. We're a very strong organization with a good ethic, but we're not speedy or agile. Your pointing out any emerging issues earlier would be helpful to us.

JofA: *Do you think it's the sheer size of the IRS that keeps it from being speedy and agile?*
Everson: Size is one element. But we've also given undue weight to getting precise answers that are always correct instead of getting guidance out promptly—after we've figured out about 90% of it—and resolving the remaining issues with a little extra time.

Time counts in this world. People need to know where we are. The IRS culture has been a little risk-averse, and that's appropriate. We can't be irresponsible; we can't constantly be correcting what we tell people. Time is not something we were always cognizant of.

But the failure to do things on a timely basis has hurt us. It has hurt compliant taxpayers, especially publicly traded corporations, to whom uncertainty is a very bad thing. Or, if they're noncompliant, it's the government that loses when the process takes too long. So time is a factor that we need to work on, and we're taking steps to improve our cycle time on things like audits.

JofA: *The Jobs Act gave the IRS authority to contract out portions of the collection program. What should tax professionals expect?*
Everson: This is an important development. More than 40 states already use private collection agencies for at least one facet of their collection activities. We're going to do it carefully, with full respect for taxpayer rights and in accordance with both our own statutory governance structure and the Fair Debt Collection Practices Act, to make sure all standards are respected.

We'll start this summer and ramp it up carefully. I recognize it's a very sensitive issue. We're going to make sure we do it responsibly.

JofA: *We're all dependent on technology. Can you update us on the progress you're making with your modernization initiative?*
Everson: When I got here we had a mixed record. We were doing some great things, like electronic filing and letting cit-

izens check the status of their refunds, but we were having difficulty delivering on some of the major systems projects, like updating our core system of taxpayer records and some of our administrative systems. I'm pleased to say we've finally started to deliver some capability in the past year. So I think we have turned the corner on modernization. We're making tough decisions in this more difficult resource environment to prioritize the work we're doing. We're making progress.

JofA: *Can you share the results of your national research program with our readers? How will you use your findings?*

Everson: We're just now completing our review of this first tranche of research. We took an in-depth look at 46,000 individual returns from 2001 for the first time since the 1988 tax year. We'll reach some conclusions over the course of 2005, and use them to adjust the way we allocate our resources, the way we conduct our audits, the relationships we look at within returns. I don't expect any startling changes, because I think we know where the greatest problem areas are from our day-to-day work. But I do think it will provide a very useful foundation for a discussion of the tax gap and of our own internal workings.

Help us stay ahead of the curve. We're a very strong organization with a good ethic, but we're not speedy or agile. Your pointing out any emerging issues would be helpful.

This is something we're going to have to keep working on. The first strip we've done is just looking at individual returns. There are a lot of other components in terms of employment taxes and partnerships and other things on which we'll need to make comparable updates over time.

JofA: *What are the most important initiatives the IRS can undertake to improve its relationships with tax practitioners?*

Everson: We need to continue to improve our delivery of information, be it online or in our publications, to make sure we provide timely and accurate responses to queries that come in to us. We still don't do as well as we should in giving accurate answers to questions that are posed to us. We've improved our telephone services a great deal; you can get through to the IRS now. But sometimes you don't get exactly the right answer. We need to do better.

JofA: *And what steps does the accounting profession need to take to improve our relationship with you?*

Everson: I would like to see the profession do a better job of holding those who get out of line accountable, of chastising them. That helps maintain the integrity of the system.

JofA: *Is there any question I didn't ask you today that you wish I had?*

Everson: I would like to talk a little more about the budget. It's a tough fight in Congress, because we're in competition with other agencies for the available funding. It's important that we secure the resources the president has asked for.

The other question is: What is the IRS's role in tax reform? The president has targeted this as a fundamental second-term initiative. We do need to simplify the code. Complexity is an enemy of compliance; if people can't understand the code, they're less likely to fulfill their obligation. I would suggest though that we don't favor a particular policy option. As policy alternatives are discussed, we need to evaluate them in terms of four different perspectives. First we need to carefully consider the impact of any policy option on attitudes toward compliance; we want to see the willingness of the citizenry to comply improve. The second thing that needs to be addressed is the administerability of any changes.

The third is that as we go through the process, we need to be careful not to evaluate a suboptimized existing system against a perfect theoretical system. You need to make an apples-to-apples comparison, understanding that even things like the VAT or other options that are used in other countries have compliance gaps associated with them.

The fourth point is that if we do make changes—if the panel proposes changes and the administration champions them and the Congress accepts them—we need to be careful in the transition period to make sure they're done smoothly and implemented well. We don't want to have the new system get off to a bad start. ■

Protect your clients' assets from creditors.

Is Your Retirement Plan Really Safe?

BY RICHARD A. NAEGELE AND MARK P. ALTIERI

ILLUSTRATION BY JOE BAKER/IMAGES.COM

Could your retirement fund be at risk? Could a simple adjustment or two shield it? A landmark ruling by the Supreme Court in 2004 and decisions by lower courts and the IRS have changed the protection offered to taxpayers on assets they hold in tax-qualified retirement plans.

As a larger-than-ever percentage of Americans approach retirement, CPAs must be aware of these new decisions—and their potential repercussions on the $12 trillion the public has invested in retirement funds. This article discusses the 2004 *Yates* v. *Hendon* case—the second most important case in history with regard to the protection of retirement assets (after the landmark *Patterson* v. *Shumate* case)—and other recent rulings on the subject, and provides CPAs with guidance on how to protect their own and their clients' 401(k)s and other retirement plan assets from creditors.

ANTI-ALIENATION PROVISIONS

The point of retirement plans, of course, is to provide taxpayers with a financial cushion in their old age. To that end, the anti-alienation provisions of the Employee Retirement Income Security Act (ERISA) section 206(d) and IRC section 401(a)(13) have protected tax-qualified retirement plans from the claims of creditors of plan participants and their beneficiaries, with three major exceptions.

Case Citations

These cases are listed in the order of their appearance in the article.

- *United States* v. *Tyson*, no. 02-X-73808 (E.D. Mich. April 9, 2003).
- *United States* v. *Clark*, no. 02-X-74872 (E.D. Mich. June 11, 2003).
- *United States* v. *Rice*, 196 FSupp. 1196 (N.D. Okla. 2002).
- *Patterson* v. *Shumate*, 112 S. Ct. 2242 (1992).
- *In Raymond B. Yates, M.D., P.C. Profit Sharing Plan* v. *Hendon, Trustee*, 124 S. Ct. 1330 (March 2, 2004).
- *In re Yates*, 287 F3d 521 (6th Cir. 2002).
- *In re Witwer*, 148 B.R. 930 (Dec., 1992, Cal.).
- *In re Lane*, 149 B.R. 760 (Jan., 1993, N.Y.).
- *In re Hall*, 151 B.R. 412 (Feb., 1993, Michigan).
- *In re Watson*, 192 B.R. 238 (Feb., 1998, Nevada), *affd.* 22 EBC 1091 (9th Cir. 1998).
- *Lowenschuss* v. *Selnick*, 117 F3d 673 (9th Cir. 1999).
- *McCaferty* v. *McCaferty*, no. 95-3919 (6th Cir. 1996).
- *Erb* v. *Erb*, 75 Ohio St. 3d 18 (1996).
- *Rhiel* v. *Adams*, no. 03-8011, 203 Fed. App. 0006P (6th Cir. 2003).
- *Hoult* v. *Hoult*, 373 F3d 47 (1st Cir. 2004), cert. denied, U.S. S. Ct. (2004).

First, qualified domestic relations orders (QDROs) were exempted under IRC section 414(p) and ERISA section 206(d)(3). Thus, retirement plan assets have been considered a marital asset subject to division in divorce and attachment for child support.

Second, the IRS staked a claim to assets held in retirement plans. Federal tax levies and judgments were exempted from ERISA protection under Treasury regulations section 1.401(a)-13(b).

Third, under IRC section 401(a)(13)(C) and ERISA section 206(d)(4), criminal or civil judgments, consent decrees and settlement agreements offset retirement benefits when the plan participants committed fiduciary violations or crimes against the plan. (For more on protections afforded retirement plans, see "What About State Laws?" below.)

Aside from these exceptions, however, funds deposited in retirement plans were safe from creditors. In the past couple of years, however, the courts and the IRS took a second look at their historic protections. In 2003 and 2004 the IRS in effect added a fourth exception by broadly construing the tax-lien exemption to encompass federal criminal penalties. In private letter rulings 200342007 and 200426027, the service said "the general anti-alienation rule of IRC section 401(a)(13) does not preclude a court's garnishing the account balance of a fined participant in a qualified pension plan in order to collect a fine imposed in a federal criminal action." The IRS cited favorably three recent federal district court cases that concluded that ERISA plans were subject to garnishment to satisfy criminal fines under the Federal Debt Collection Procedures Act of 1977 (FDCPA). (Also see *United States* v. *Tyson*; *United States* v. *Clark*; *United States* v. *Rice*.)

The FDCPA provides that "an order of restitution…is a lien in favor of the United States on all property of the person fined as if the liability of the person fined were liability for a tax assessed under the Internal Revenue Code…." The IRS accepted the reasoning of the courts that retirement funds fell within the exception to the anti-alienation provision listed in Treasury regulations section 1.401(a)-13(b)(2)(ii) for "collection by the United States on a judgment resulting from an unpaid tax assessment."

What About State Laws?

Neither ERISA nor IRS protections apply to assets held under individual retirement arrangements (including SEPs and SIMPLE IRAs), government plans, or most church plans. IRAs are protected from creditors in many states by law, based on the IRA owner/participant's state of residency.

But ERISA provisions supersede state laws relating to employer-sponsored employee benefit plans. The ERISA anti-alienation and preemption provisions combine to protect ERISA-covered employee benefit plans from state attachment and garnishment laws.

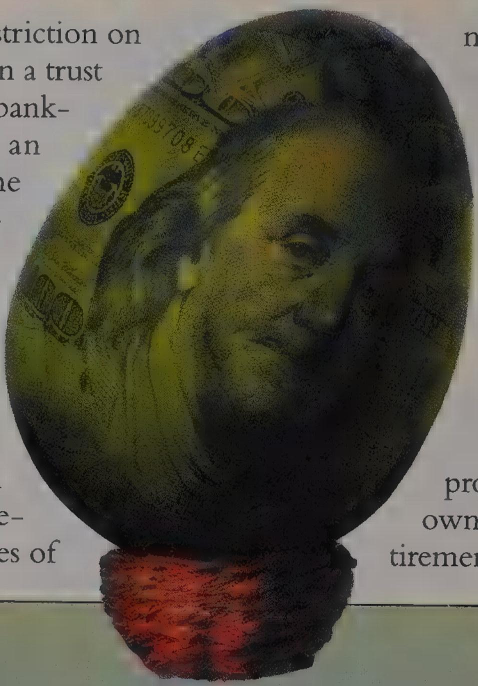
RETIREMENT ASSETS IN BANKRUPTCY

The historic U.S. Supreme Court ruling that has protected retirement plan assets for the past 12 years is *Patterson* v. *Shumate*. In it the court resolved a split among the U.S. Circuit Courts of Appeals by holding that ERISA's prohibition against the assignment or

alienation of pension plan benefits was a restriction on the transfer of a debtor's beneficial interest in a trust that was enforceable under applicable nonbankruptcy law. Thus, a debtor's interest in an ERISA pension plan was excluded from the bankruptcy estate and not subject to attachment by creditors.

In 2004 the Supreme Court issued another significant ruling, *Raymond B. Yates, M.D., P.C. Profit Sharing Plan* v. *Hendon, Trustee*, that reversed the previous decision of the U.S. Sixth Circuit Court of Appeals in *In re Yates*. The Sixth Circuit had said Dr. Yates, as a sole shareholder, was not an "employee" for purposes of ERISA and, therefore, was not entitled to ERISA creditor protection; the Supreme Court rejected the position that a working owner could not rank as both "employer" and "employee." The Supreme Court held that the working owner of a business (here, the sole shareholder and president of a professional corporation) could qualify as a "participant" in a pension plan covered by ERISA if the plan included one or more employees other than the business owner and his or her spouse. This owner, in common with other employees, qualifies for the protections ERISA affords plan participants and is governed by the rights and remedies ERISA specifies.

Planning tip. CPAs should review their own and their clients' retirement plans to ensure they include nonowner employees as well as owners and their spouses, so that the assets of business owners and their spouses are protected from creditors in case of bankruptcy.



Value of Assets in Retirement Savings

Between 1975 and 1999, the total value of assets set aside in pensions, 401(k) plans and IRAs increased to more than $12 trillion from $400 billion.

Source: National Bureau of Economic Research, **www.nber.org**, 2004.

OWNER-ONLY PLANS ARE AT RISK

Since *Patterson*, several U.S. bankruptcy courts have ruled that assets in a retirement plan that benefits only the business owner (and or the sole owner's spouse) may be attached by creditors if the owner goes bankrupt. The bankruptcy courts have held ERISA is meant to benefit common-law employees, while a sole owner is an employer. (See *In re Witwer*, *In re Lane*, *In re Hall*, *In re Watson*.) Thus, a retirement plan that covers only the owners of a business may be attached by the bankruptcy creditors of the owner/plan participant.

Department of Labor regulations also provide that a husband and wife who solely own a corporation are not employees for retirement plan purposes and that a plan that covers only partners or sole proprietors is not protected under Title I of ERISA. However, a plan that includes one or more common-law employees (in addition to the owners) is protected, making ERISA protections applicable to all participants.

In *Yates* v. *Hendon*, the U.S. Supreme Court noted that the Department of Labor interprets the Code of Federal Regulations to mean that the statutory term *employee benefit plan* does not include one whose only participants are the owner or his or her spouse, but does include plans that cover one or more common-law employee, in addition to the self-employed individuals. The Supreme Court said "this agency view merits the Judiciary's respectful consideration."

In *Lowenschuss* v. *Selnick*, the U.S. Ninth Circuit Court of Appeals held that an ERISA-qualified employee pension benefit plan could lose its ERISA status for bankruptcy purposes if nonowner participants left and it covered only the owner-employee at the time of the bankruptcy filing. The court also said section 541(c) of the Bankruptcy Code invalidated certain nonbankruptcy state law protections for retirement benefits.

EXECUTIVE SUMMARY

- **BENEFITS IN TAX-QUALIFIED RETIREMENT PLANS** generally are protected from the creditors of plan participants and insulated from claims in bankruptcy.
- **PLANS NOT PROTECTED FROM CREDITORS** are those that cover only the business owner and/or the owner's spouse and section 403(b) tax-sheltered annuity plans whose assets are held in custodial accounts rather than in trusts.
- **RETIREMENT PLAN ASSETS ARE MARITAL ASSETS** subject to division in divorce or attachment for child support by a qualified domestic relations order.
- **RETIREMENT PLAN ASSETS MAY BE SUBJECT TO** attachment by federal tax levies, judgments and fines imposed in federal criminal actions. Treasury regulations provide that plan benefits are subject to attachment by the IRS.

RICHARD A. NAEGELE, JD, is an attorney and shareholder at Wickens, Herzer, Panza, Cook and Batista in Avon, Ohio. His e-mail address is rnaegele@wickenslaw.com. MARK P. ALTIERI, CPA/PFS, JD, is an associate professor of accounting at Kent State University and special tax counsel to Wickens, Herzer, Panza, Cook and Batista. His e-mail address is maltieri@wickenslaw.com.

Planning tip. A retirement plan can lose its creditor protection if it does not benefit nonowner employees. It is important for CPAs to ensure that plans always contain benefits for nonowner employees to protect plan assets from creditors.

BANKRUPTCY AND QDROs

The U.S. Sixth Circuit Court of Appeals in 1996 in *McCaferty* v. *McCaferty* ruled that pension benefits awarded to a participant's former spouse under a qualified domestic relations order before the participant filed for bankruptcy didn't qualify for bankruptcy protection and must be paid to the former spouse. The court held that the divorce decree created a "constructive trust" to protect the interest awarded to the former spouse in the pension plan even though the divorce decree did not use the words *constructive trust.*

The Sixth Circuit opinion was consistent with the earlier 1996 ruling of the Ohio Supreme Court in *Erb* v. *Erb*, which said the spouse's property interest in the participant's pension was not part of the bankruptcy estate.

403(b) PLANS MAY NOT BE PROTECTED

The United States Sixth Circuit Court of Appeals held in 2003 in *Rhiel* v. *Adams* that only assets held "in a trust" could be excluded from bankruptcy by section 541(c)(2) of the Bankruptcy Act. Earlier, the bankruptcy court for the Southern District of Ohio had held that IRC section 403(b) plans (for the husband and wife) were "ERISA-qualified" as defined by the Supreme Court in *Patterson* v. *Shumate* and were not the property of the bankruptcy estate. The Sixth Circuit reversed that decision and remanded the case for further proceedings, saying the debtors had not shown that section 541(c)(2) "in a trust" language had been satisfied. The Sixth Circuit said that only assets of an ERISA plan held in a trust would be excluded from the bankruptcy estate and that assets in a custodial account could not be excluded.

Planning tip. If your clients are employees of public schools or tax-exempt organizations and participate in a 403(b) plan with a custodial account, their retirement plan benefits may not be protected from creditors. Investigate whether it's possible to transfer the assets to a 403(b) plan with a trust account to obtain creditor protection.

DISTRIBUTED BENEFITS NOT SAFE

The U.S. First Circuit Court of Appeals held in the *Hoult* v. *Hoult* case of 2004 that the anti-alienation provisions of ERISA and the Internal Revenue Code don't protect pension benefits that already have been removed from retirement plans and distributed to plan participants or beneficiaries.

Planning tip. Advise clients facing possible bankruptcy to withdraw only the minimum required annual distributions from their retirement plans to shield the balance from creditors.

BEWARE OF THE RISKS

The rights of retirement plan participants to ward off creditors of all types are formidable, and ERISA's anti-alienation protections are extensive. Still, some details have changed under recent rulings by the courts and the IRS, and CPAs need to stay current to protect their own retirement plans and those of their clients. ■

RESOURCES

AICPA Resources

CPE

- Financial Issues of Aging, a self-study course (# 731781JA).
- High-Powered Tax Planning Strategies for Your Best Clients, a self-study course (# 731652JA).
- Qualified Benefit Plans: Taxation and Administration for Small to Mid-Sized Companies, a self-study course (# 731900JA).
- Qualified Retirement Plans—401(k), Keogh, SEP, Simple…Does Your Plan Still Meet Your Needs?, a self-study course (# 731870JA).
- Tax, Health Care and Asset Protection for Aging Clients, a self-study course (# 732076JA).

Web site

www.360financialliteracy.org, AICPA's 360 Degrees of Financial Literacy, offers information on personal finance topics including retirement plans.

Other Resources

- **www.benefitslink.com**, Benefits Link, offers compliance information and tools for employee benefit plan sponsors, providers and participants.
- **www.dol.gov/ebsa**, Employee Benefits Security Administration, gives compliance information.

PRACTICAL TIPS TO REMEMBER

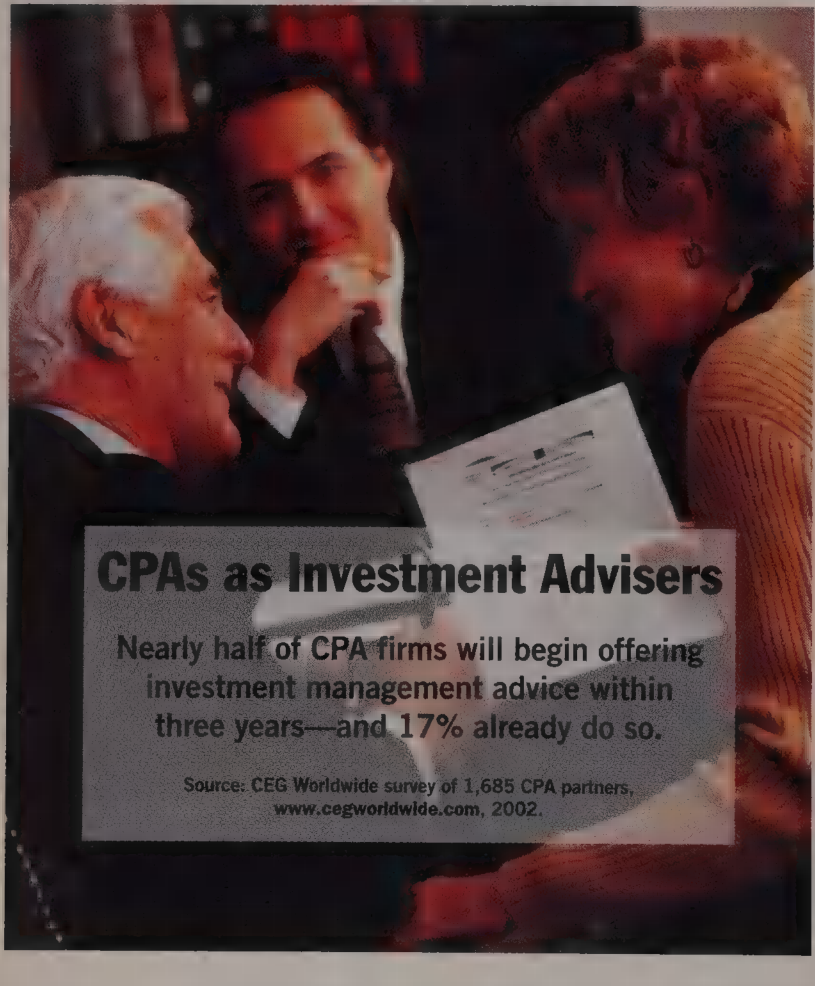
- Make sure retirement plans include nonowner employees as well as owners and their spouses so that assets of business owners and their spouses are protected from creditors in case of bankruptcy.
- Consider transferring assets of employees of public schools and tax-exempt organizations to 403(b) plans with trust accounts.
- Advise clients facing possible bankruptcy to withdraw only the minimum required annual distributions from their retirement plans to shield the balance from creditors.

Take your registered investment advisory practice to the next level.

Build Customized Bond Portfolios

BY STUART ZIMMERMAN

Firms seeking to broaden client relationships and increase revenue can meet both objectives by expanding fixed-income services to include laddered and other types of individual bond portfolios. During the past decade, many CPA firms have created fee-only registered investment adviser (RIA) affiliates in their firms or outsourced the function to RIA specialists, building the assets under their management by cultivating investment philosophies that appeal to high-net-worth clients.



CPAs as Investment Advisers

Nearly half of CPA firms will begin offering investment management advice within three years—and 17% already do so.

Source: CEG Worldwide survey of 1,685 CPA partners, www.cegworldwide.com, 2002.

In this article, CPAs will find suggestions for offering clients specialized fixed-income platforms. In particular, advisers can offer high-net-worth clients the opportunity to move from bond mutual funds to individual customized bond portfolios. The article also discusses some of the obstacles firms might encounter when introducing new fixed-income services.

ELEMENTS OF A CUSTOMIZED PORTFOLIO

Relying on bond mutual funds usually is the most prudent strategy for portfolios under $500,000, but for larger amounts, firms should consider designing a bond portfolio of individual securities that meet the unique financial goals and risk tolerance of each client.

Bond funds and a portfolio of individual bonds are not the same. If a client invests the fixed-income portion of a 60/40 portfolio worth $2 million in a bond fund with a 0.50% annual fee, the portfolio loses value paying for expenses such as commissions and portfolio turnover. And the bond fund holdings don't reflect the client's specific income needs, tax situation and risk tolerance. But a client with an individual bond portfo- *(continued on page 40)*

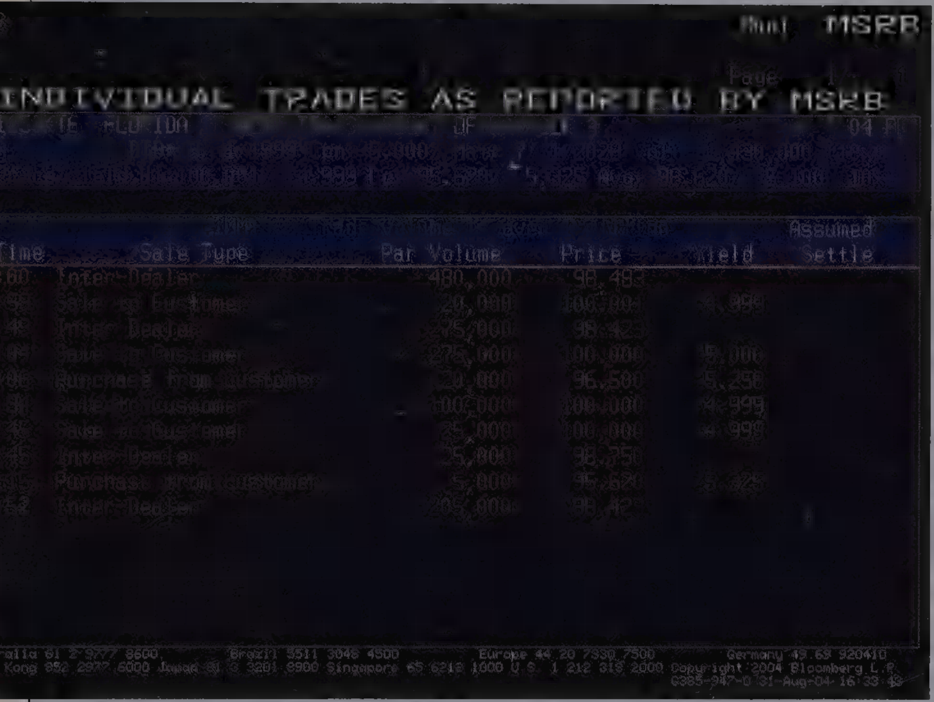
PHOTOGRAPH BY ROB LEWINE/CORBIS

Explaining Bond Markups

If your clients have existing individual bond portfolios, chances are good they have purchased bonds with excessive markups of which they are unaware. Once made aware, they will want to know how the markups occurred. Discussing markups with your clients will show them how your firm adds value by avoiding excessive costs.

A markup (or markdown) is the difference between the price dealers transact among other dealers and the price the customer pays. When clients see transaction fees on their trade confirmations and portfolio statements, they might assume these are the bond's only cost. Markups, whether reasonable or excessive, do not appear on portfolio statements, but in reality, the practice of charging them when investors buy or sell bonds is more prevalent than most investors realize.

This exhibit represents a typical bond issue being bought and sold at a variety of prices. All four dealer-to-dealer transactions (identified in the Sale Type column as



"Inter-Dealer" transactions) were priced between \$98.423 and \$98.75, a relatively tight range. In contrast, the highest price a retail client received for selling the issue (Purchase from Customer) was \$96.50, about 2% below the dealer price. The lowest price a retail client received when purchasing the issue (Sale to Customer) was \$100, about 1.5% above the range of dealer prices. The difference in prices between those at which the retail clients could buy and sell, versus those the dealers paid or received, represent dealer markdowns and markups.

Legal Requirements Regarding Markups/Markdowns

Currently there is no legal requirement that markups and markdowns be disclosed to investors. The Municipal Securities Rulemaking Board states in its General Rule G-30 that prices and commissions for bond transactions must be fair and reasonable, "taking into consideration all relevant factors, including the best judgment of the broker…as to the fair market value of the securities at the time of the transaction." For the first quarter of 2004, 97 of the 100 most excessive municipal trades included markups ranging from 6.753% to 15% according to Kevin Olson, who maintains a public service information site, **www.municipalbonds.com**, which advocates fair disclosure of municipal bond disclosure information.

Why So High?

There are at least three reasons why the hidden costs associated with purchasing bonds might be even higher than costs of purchasing stocks: the way bonds are traded, the amount of publicly accessible information available about bonds, and the potential objectives of broker-dealers who hold large in-house bond inventories.

Trades. Bonds traded "over the counter," where dealers trade with each other, differ from stocks traded on a public exchange. Bond dealers maintain an inventory of bonds, and take on the additional risk of whether they will be able to sell the bonds for more than they themselves paid for them. Thus, they consider reasonable markups to be fair compensation.

Public information. Second, the amount of information available about stocks greatly outweighs information on bonds. Bond prices are not listed in the local newspaper and tracking them efficiently is difficult. There were approximately 2,750 companies listed on the NYSE at the end of 2003, but there were two million separate municipal bond issues outstanding.

Objectives. Finally, bonds quite frequently come from the broker–dealer's own in-house inventory. In many instances a broker is torn between the competing objectives of reducing the company's exposure to market risk (from holding an issue in the face of future unforseen interest rate changes) vs. doing a thorough search for a bond that better meets a client's unique risk tolerance or individual portfolio needs.

Most clients appreciate hearing about markups and how bond transactions occur. When clients know how bonds trade and the real costs associated with such transactions, they become aware of the benefits of working with a firm that has an established fixed-income department with multiple broker–dealer relationships. It can add value to the client-adviser relationship when clients know that their adviser is actively seeking to avoid excessive markups or markdowns while searching multiple sources for a bond that meets their needs.

lio through a fee-only RIA typically pays only a charge per transaction for bond purchases and sales. (This does not include any markups or markdowns on the bond price, discussed later in this article.)

There are two broad ways a portfolio can be invested—actively or passively. Active investors assume that the market is generally "inefficient," so they regularly exploit opportunities when holdings are trading for more or less than they are actually worth. For investors to succeed at active investing, opportunities need to be of sufficient frequency and value to cover the cost of consistently seeking and executing trades. A passive investor, on the other hand, assumes that the opportunities to exploit inefficiencies are too few and far between to effectively pursue. There is a great deal of academic evidence indicating that the collective wisdom of all market players results in highly efficient markets that reflect fair pricing almost instantaneously upon release of any news that might affect a holding's price.

Adopting a passive approach to fixed income lets firms minimize the management costs incurred by clients. In actively managed fixed-income programs, the portfolio manager attempts to beat the market by trading bonds he or she believes the market has under- or overvalued, or timing the direction of future interest rate movements. In passively managed fixed-income programs, the adviser constructs bond portfolios based on a carefully planned investment policy designed to achieve the client's long-term objectives. Passive managers achieve their goals by evaluating appropriate bonds that fit particular specifications for that client's unique fixed-income portfolio, narrowing the final bond selection based on minimizing markups (during buys) and markdowns (during sells), and ensuring sufficient bond quality to minimize the chance for default, calls or other unexpected events that can cause a portfolio to veer off course from its goals.

In addition to serving the best interests of clients, introducing customized fixed-income portfolios can add value to a firm by

- Increasing the likelihood that advisers ultimately will direct the majority of clients' assets.
- Boosting the firm's overall revenue by offering a new service.
- Smoothing the firm's revenue streams from the swings created by equity-only RIAs, which can facilitate capital spending decisions and simplify staffing decisions (such as reducing the need for layoffs during low periods and correctly identifying when to hire for long-term growth).
- Increasing a firm's ability to compete with other local firms that offer individual bond portfolio services.

BUILD A SUCCESSFUL FIXED-INCOME SERVICE

CPAs considering offering individual bond portfolio services must think carefully about the additional costs and regulatory oversight involved in building an internal infrastructure to provide such services.

A firm cannot clone all the staff and processes used for equities onto a new fixed-income service; fixed-income portfolios are fundamentally different. Specifically, three steps are key to the success of a firm that offers individual bond portfolios: establishing cost-effective quality broker-dealer relationships; assuming additional managerial overhead including staffing adjustments and reporting procedures; and supporting staff education and training.

Step One:

ESTABLISH COST-EFFECTIVE RELATIONSHIPS

To expand fixed-income services, your firm must have its own in-house trading department or outsource it to an established fixed-income provider. Regardless of your deci-

EXECUTIVE SUMMARY

- **FOR HIGH-NET-WORTH CLIENTS** with fixed-income investable assets over $500,000, firms might consider designing customized bond portfolios that meet each client's unique financial goals and risk tolerance.

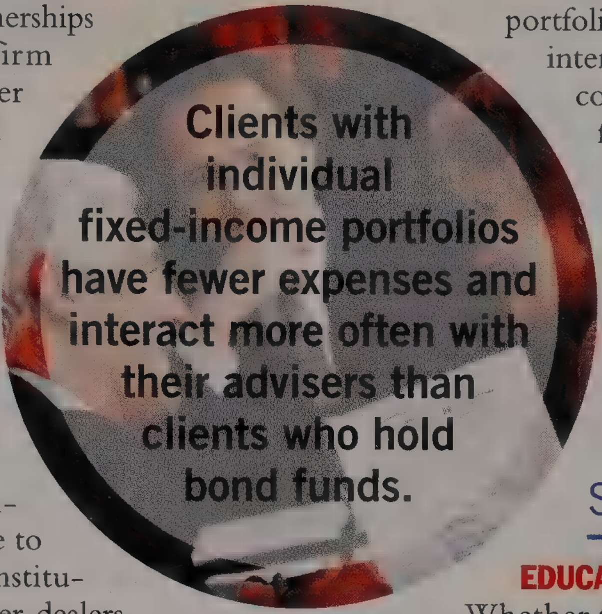
- **IN ADDITION TO SERVING THE BEST INTERESTS** of clients, CPAs introducing such customized fixed-income portfolios also add value to their firm by broadening the relationship with the client, boosting overall revenue, contributing to stabilizing the firm's revenue profile and increasing the firm's ability to compete.

- **CPAs/RIAs CAN CREATE A CUSTOMIZED** portfolio for a client by acquiring bonds with stylized characteristics (such as different credit qualities, AMT status and call features) and by choosing either municipals or taxable issues (or both depending on the client's tax concerns).

- **A FIRM THAT CHOOSES TO BUILD** internal infrastructure instead of outsourcing must establish cost-effective relationships with broker-dealers; invest in the managerial overhead necessary to create an operational fixed-income service; and train staff about customized fixed-income portfolios.

STUART ZIMMERMAN, CPA/PFS, is a principal and founder of Buckingham Asset Management Inc. in St. Louis and a managing member of BAM Advisor Services, a turnkey provider of back-office services for fee-only RIAs (**www.bamservices.com**). His e-mail address is stzimmerman@bamstl.com.

sion, high-quality broker-dealer partnerships are important, and here's why: A firm must create enough purchasing power to buy and sell bonds with minimal markups and markdowns. "How do you become an important client [with a broker]?" asks Marilyn Cohen, author of *The Bond Bible* (Prentice Hall Press, 2000). "Number one, you need to have a lot of money; and number two, you need to do numerous transactions throughout the year."



If your firm decides to trade in-house, you can expect it to take time to build up the volume to command institutional bond prices with multiple broker-dealers. And it's costly for a firm to subscribe to a financial information system such as Bloomberg, properly analyze bond characteristics and availability, buy portfolio reporting software to create client report, and obtain legal counsel and insurance.

If your firm outsources to an ally that serves as a liaison between you and the bond broker-dealers, that ally should already have these elements in place, as well as established relationships with multiple broker-dealers. Such an arrangement can help you more quickly and cost-effectively build an established department with strong purchasing power.

Partnering is better than trading directly with broker-dealers for a number of other reasons as well. Chief among them is the fact that if a client's bond portfolio is constructed with bonds from a broker-dealer, the client likely will pay more for the bonds because of higher markups attached to such bonds. A transaction fee is not the same as the markup on a bond, so the cost of these markups remains unseen by the client. (See Explaining Bond Markups, page 39.)

Also, broker-dealers do not use the same compensation model as fee-only RIAs. The fee charged by an RIA is transparent; charging flat fees for a menu of services based on assets under management is a reasonable way of serving a client's interests. Conversely, a broker-dealer representative works on commission. Commissions produce an incentive for the broker-dealer to buy and sell more frequently and to sell from his or her existing bond inventory, where commissions often are higher.

Step Two:

MANAGE OVERHEAD

Creating an in-house fixed-income service requires the firm to invest in managerial overhead and personnel, including retaining staff with specialized bond knowledge and adding resources needed for added compliance oversight. Staff will be involved with tax-loss harvesting, monitoring the portfolio for credit changes and monitoring interest rate changes that could affect income streams due to the embedded call features in individual portfolios. In addition, the firm will need to establish new reporting procedures for internal execution, settlement and reconciliation, and problem resolution. The firm also must create best execution procedures and processes that cover all aspects of the broker-dealer relationship.

Step Three:

EDUCATE STAFF AND CLIENTS

Whether the firm is managing fixed-income services internally or outsourcing them, it's vital that firm members communicate effectively with clients about the mechanics of individual bond portfolios. That requires educating staff about fixed income—and then educating clients. Clients who are heavily tilted toward equity in their globally diversified portfolios might be confused when they hear that a bond portfolio includes only high-grade issues and carries no high-yield component. "If it is worthwhile to hold value stocks," they might ask, "why not follow the same rule and hold high-yield bonds in a bond portfolio?" You and your staff's ability to answer client questions with confidence adds value to the client-CPA relationship, which can ultimately grow the overall assets under management of the firm.

BECOME CLIENT-CENTRIC

Moving from basic fixed-income vehicles to individual bond portfolios can benefit the overall portfolios of many high-net-worth clients. Clients with individual fixed-income portfolios have fewer expenses and interact more often with their advisers than clients who hold bond funds. Before buying any bonds, though, advisers should thoroughly understand the client's financial situation, financial goals and unique risk tolerance.

To create a customized portfolio for a client, advisers would acquire either municipals or taxable bonds (or both depending on the client's tax concerns) with stylized characteristics (such as different credit qualities, AMT status and call features). For example, a portfolio should be constructed with bonds that have a higher credit quality (rated A or higher). In general, customizing a bond portfolio allows advisers to determine the timing and magnitude of realizing taxable events and can facilitate overall tax planning.

A client whose portfolio is passively invested can receive all the benefits of a separately managed account (SMA) program minus the expenses that some-

AICPA RESOURCES

CPE

- Investment Planning—The Risks and Rewards, a self-study course (# 730818JA).
- Managing Client Expectations in an Uncertain Market, a self-study course (# 056512JA).

times support active management, such as hiring well-known managers, adding staff to search for bonds that might outperform the market, or purchasing expensive equipment and software for the purpose of timing the market. A high-quality fixed-income component helps clients remain true to well-planned investment policies. Still, advisers should be aware of the costs associated with fixed-income portfolios: the expenses associated with purchasing bonds from a broker-dealer, most notably potentially excessive markups and markdowns which are covered elsewhere in this article.

PRACTICAL TIPS TO REMEMBER

- For amounts over $500,000, consider a bond portfolio consisting of individual securities that meet the unique financial goals and risk tolerance of each client and facilitate overall tax planning.
- To quickly and cost-effectively build an established department with strong purchasing power, align with partners that have specialized bond knowledge and resources in place, and established relationships with multiple broker-dealers.
- Beware of excessive markups or markdowns and bonds that come from a broker-dealer's own in-house inventory.
- Access a service (such as Bloomberg's) that can provide accurate bond pricing information.

BE READY TO SERVE

CPAs can distinguish themselves with clients via the application of high-quality customized bond portfolios under the appropriate circumstances. Many clients who desire customized portfolios first will look to their CPAs to provide them with individual fixed-income services. For CPAs with RIA affiliates capable of providing them, offering clients alternatives to bond funds and other collective investment vehicles can add value to the client's portfolio, strengthen the relationship between the client and the firm, and add value to the firm. Even when bond funds are the appropriate solution, clients still can benefit from learning about other fixed-income options available to them; individual bonds might become appropriate based on changes in the client's financial and life circumstances (such as retirement, change in marital status or inheritance). CPAs who offer client education as an important part of the client-adviser relationship can succeed in enhancing client experiences for the lifetime of their portfolios. ■


OBJECTS IN PORTFOLIO MAY BE LARGER THAN THEY APPEAR.

The AICPA peer review board has enhanced the standards.

Peer Review Is Stronger and Better Now

BY DAVID JENTHO AND DEAN BEDDOW

The right kind of peer pressure can be a good thing—a fact proven by the profession's peer review program. Since its inception nearly 20 years ago, participating firms have reaped the benefits of having colleagues assess the quality of their work. Now, after almost two decades, the AICPA has taken a look at the program to strengthen the process.

Peer reviews are carried out in compliance with the AICPA peer review board under the supervision of a state CPA society or group of state societies that the board approves. Over the past year the board evaluated the program and revised its standards for performing and reporting on peer reviews for firms that do not audit SEC registrants. In the process it has affirmed that enhancing the quality of firms' accounting and auditing practices and protecting the public interest are equally important objectives. The resulting modifications to PR section 100 of AICPA Professional Standards, "Standards for Performing and Reporting on Peer Reviews," are designed to improve the quality of reviews and increase the usefulness of the resulting reports to the public, to the regulators that rely on them and to the reviewed firms.

The revised standards will affect all 30,000 firms enrolled in the AICPA peer review program and the state societies that administer it (administering entities). Firms will notice changes in the reports and will need to implement additional procedures for their next peer review. The revisions affect timing, engagement selection, peer review reporting and the oversight process. This article describes several—but not all—enhancements that will affect participating firms.

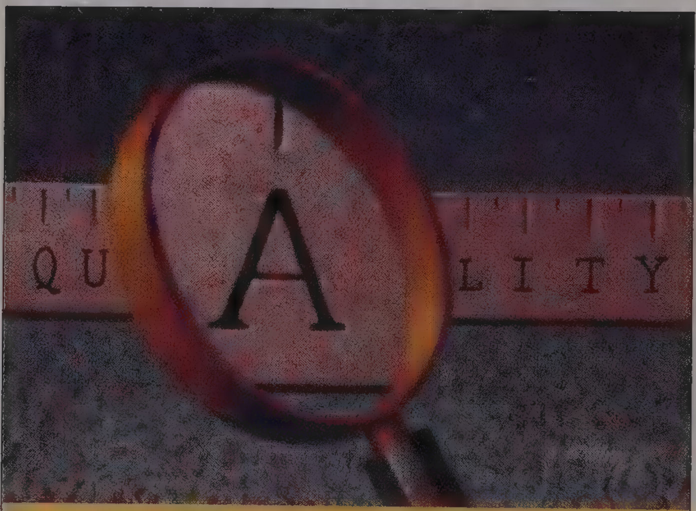


ILLUSTRATION BY ROB COLVIN/IMAGES.COM

Who Administers Them?

State CPA societies administer the AICPA peer review program for firms headquartered in that state or arrange for another state society to administer them. Currently 41 state societies administer reviews for the 54 licensing jurisdictions (including the District of Columbia, Guam, Puerto Rico and the Virgin Islands).

THE TYPES REMAIN THE SAME

There are still three types of peer reviews: system, engagement and report reviews.

System reviews. Firms that perform engagements under AICPA and government auditing standards or those that examine prospective financial information under AICPA attestation standards still will have system reviews.

Engagement reviews. Peer reviews of firms that perform accounting and review services and/or attestation engagements under Statements on Standards for Accounting and

Review Services and/or Statement on Standards for Attestation Engagements, respectively, are called engagement reviews.

Report reviews. Peer reviews of firms that perform only compilation engagements under SSARS where the firm has compiled financial statements that omit substantially all disclosures are called report reviews.

AICPA RESOURCES

The AICPA peer review program is dedicated to enhancing the quality of accounting, auditing and attestation services performed by AICPA members in public practice. For more peer review information and resources go to **www.aicpa.org** and type in "peer review program," or call the AICPA at 888-777-7077.

For peer reviews commencing on or after January 1, 2005, peer reviewers should consult guidance materials available at **www.aicpa.org/members/div/practmon/index.htm**.

TIMING IS EVERYTHING

The public has a reasonable expectation that every firm performing an audit have its working methods validated by a system review. Firms performing audits for the first time, or those that perform such services only occasionally, may have a higher risk of noncompliance with professional standards because of lack of experience. Consequently, the standards now require firms that have participated in an engagement or report review and subsequently performed an engagement requiring a system review (such as a first audit) to (a) immediately notify the administering entity and (b) undergo a system review. The system review will be due 18 months from the year end of the engagement requiring a system review (or 18 months from the date of the report for financial forecasts and projections) or the firm's next scheduled due date, whichever is earlier.

FIRM REPRESENTATIONS

Reviewed firms also will provide written representations concerning the information they give to peer reviewers and administering entities. The representations will assure the peer reviewer that the firm

- Is not aware of any situations where it or its personnel have not complied with the rules and regulations of state board(s) of accountancy or other regulatory bodies (including applicable firm and individual licensing requirements for each state in which the firm practices for the year under review).
- Has made available to the reviewer any communications related to allegations or investigations.
- Has provided the reviewer with a list of all client engagements that concluded during the year under review.
- Has provided all the other information that the reviewer has requested.

The new requirements call for firms to notify the peer reviewer of any communications about allegations or investigations (including litigation) relating to the conduct of an accounting, audit or attestation engagement performed and reported on by the firm. The objective of such communications is to enhance peer review, and minimize risk for both reviewer and firm, by allowing the peer reviewer to better plan and perform the review, including identifying offices, owners and engagements that should get greater scrutiny during the process.

ENGAGEMENT SELECTION

The board always has required the peer reviewer, during planning, to notify the subject firm which engagements have been selected for review. The changes say that, for system reviews, peer reviewers must notify the firm no earlier than two weeks before commencement of the review which engagements will be reviewed. However, the review team will hold back notification of at least one engagement from the initial review list until fieldwork begins at the subject firm's offices. That engagement should be the firm's highest level of service that does not increase the scope of the review. It is hoped this change to the peer review program will add credibility to the program and strengthen reliance on it by regulators and other third parties.

Another revision ensures that the engagement selected at commencement of the review is available to the peer reviewer during the fieldwork phase. If the engagement cannot be provided at this time, the peer reviewer will inform the firm that a limitation in the scope of the review exists. In addition, the peer review report will be modified to include the fact that the firm did not make available an engagement selected for review.

Firms undergoing a system review may have reasons to exclude an engagement from being selected for review (for example, if that engagement is the subject of litigation). Firms that wish to exclude an engagement must request a waiver from the scope limitation report modification.

Firms should send the written request to the administering entity identifying:

- The engagement(s) the firm plans to exclude from peer review selection.
- The reasons for the exclusion.
- A request for a waiver from a scope limitation in the peer review report.

The administering entity is responsible for determining whether modifying the peer review report to reflect the limitation in scope is required. Administering entities will consider several factors including, but not limited to, whether the review team will be able to obtain a reasonable cross-section of engagements to review. The administering entity will review the reasonableness of the firm's explanation and notify the firm in writing whether a scope limitation in the peer review report is required.

REPORTS AND LETTERS OF COMMENTS

Firms will notice significant changes in their peer review reports and letters of comments designed to enable users to better understand the peer review process and any matters

identified during reviews. Here is a summary of the significant revisions:

- System review reports will include a brief description of the system review process.
- When a subject firm performs audits of employee benefit plans, engagements adhering to government auditing standards or audits of certain depository institutions with assets of $500 million or more, system review reports will state that such engagements were selected as a part of the peer review.
- All deficiencies and recommendations resulting in a modified or adverse opinion will be included in the system or engagement review report. Adverse reports no longer will have a letter of comments, since all matters will be included in the report.
- If a system (or engagement) review report is modified or adverse, any resulting substandard engagements will be identified and will include industry and level of service. The standards define a substandard engagement as one in which the deficiencies identified, individually or in aggregate, are material to understanding the report or the financial statements accompanying the report, or represent omission of a critical accounting, auditing or attestation procedure(s) required by professional standards.
- Peer review reports will refer to the letter of comments (especially because users of the reports should be aware when a letter of comments is issued).
- For system review reports, the elements of quality control headings no longer will be included in the letter of comments.
- For report reviews, significant deficiencies identified during the review will be clearly expressed in the report.

A firm's letter of response will address its plans to correct not only the findings in the letter of comments but also any deficiencies identified in modified and adverse reports.

OVERSIGHT

All peer reviews are subject to oversight by the AICPA and the administering entities. To improve the overall process and provide more credibility to the program, the board has strengthened the oversight policies and procedures. Those include but are not limited to

- Selecting for oversight a minimum number of audits of employee benefit plans, engagements adhering to government auditing standards and audits of certain depository institutions with assets of $500 million or more.
- Selecting at least 2% of all peer reviews for oversight.
- Having team members participate in the exit conference in some circumstances.
- Verifying reviewer qualifications to perform peer reviews.
- Timing in the performance and acceptance of peer reviews.

Those are some of the enhancements to the standards that went into effect for all peer reviews commencing on or after January 1, 2005. The standards, interpretations and additional guidance related to the revisions are on the AICPA Web site, **www.aicpa.org**. A white paper, also available on the Web site, explains the reasoning behind some of the revisions to the standards.

After much thoughtful discussion, the peer review board believes the adopted enhancements help ensure that the program continues to support the highest quality of accounting and auditing practices of public accounting firms and that its objectives are relevant, efficient, modern and valid. ■

EXECUTIVE SUMMARY

- **THE AICPA REVISED ITS STANDARDS** for performing and reporting on peer reviews for firms that do not audit SEC registrants. The revised standards, effective for reviews commencing on or after January 1, 2005, will enhance the quality of peer reviews and increase the usefulness of peer review reports to the public and regulators as well as to reviewed firms.

- **THE REVISED STANDARDS AFFECT ALL 30,000** firms enrolled in the AICPA peer review program. The revisions include elements such as timing, engagement selection and peer review reporting.

- **THE PUBLIC HAS A REASONABLE EXPECTATION** that the working methods of every firm performing an audit be validated by a system review. The enhancements have not changed the fact that there are three types of peer reviews: system, engagement and report reviews.

- **FIRMS UNDERGOING ANY TYPE OF PEER REVIEW** are required to assure the peer reviewer in writing that the firm is not aware of any situations where it or its personnel have not complied with the state board(s) of accountancy or other regulatory bodies.

- **FIRMS THAT WISH TO EXCLUDE AN ENGAGEMENT** from peer review must request a scope limitation waiver. The administering entity will review the request, satisfy itself as to the reasonableness of the firm's explanation and notify the firm in writing whether a scope limitation in the peer review report is required.

- **FIRMS WILL NOTICE SIGNIFICANT CHANGES** in their peer review reports and letters of comments. The revisions will enable users of peer review reports to better understand the peer review process and the matters identified during such reviews.

DAVID JENTHO, CPA, is a partner at Ratliff and Jentho in Baytown, Texas, and chairman of the AICPA peer review board. DEAN BEDDOW, CPA, is a senior technical manager in the AICPA peer review team. His e-mail address is dbeddow@aicpa.org. Official positions are determined through certain specific committee procedures, due process and deliberation.

This do-it-yourself job can save an office a great deal of money.

Mass Mailings Made Simple

BY BONNIE BRINTON ANDERSON, LARYSA V. OPYRA AND MARSHALL B. ROMNEY

You want to tell 130 clients about several new professional services and send them updated fee schedules. You considered outsourcing the project to a direct-mail ad agency and found the setup alone for each variation of the letter was $65—way over your budget. Worry not. This is a job your support staff should be able to handle after reading this article.

We'll use Microsoft Office's **Mail Merge** function, which merges and integrates documents and data sources, to customize the letters. The final product will be 130 personal letters to each client's contact person.

The setup takes just a few minutes. You have two options: Use the **Mail Merge** toolbar (exhibit 1, below)—a shortcut method that you'll probably prefer once you get the hang of it—or the wizard, which takes you through the process step-by-step. We'll demonstrate the process with the wizard so you can see how each step works.

To open the wizard, click on **Tools**, point to **Letters and Mailing** and click on **Mail Merge**. Your screen should resemble exhibit 2, page 49; however, yours obviously won't have the main document letter we prepared to illustrate the process. Notice that our letter lacks a contact person's name, an address or a salutation; we will add that later. Notice, too, that on the bottom right-hand side of the screen the wizard is ready for you to launch the first of six steps.

> **Key to Instructions**
>
> To help readers follow the instructions in this article, we use two different typefaces:
>
> ■ **Boldface type** is used to identify the names of icons, agendas and URLs.
>
> ■ Sans serif type shows commands and instructions users should type into the computer and the names of files.

■ *Step 1:* Under **Select document type**, click on **Letters** because that is the type of document you want to create. Then click on **Next: Starting document** at the bottom right of the screen, to bring up the screen shown in exhibit 3, page 49.

■ *Step 2:* Under **Select starting document**, choose the setup for your letter from the following options: If you are starting from scratch, click on *(continued on page 50)*

Exhibit 1

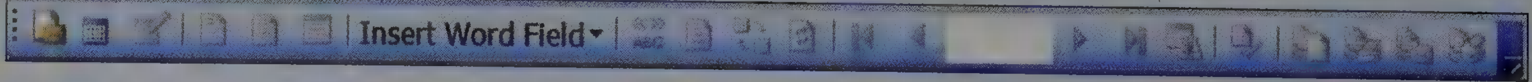


Exhibit 2

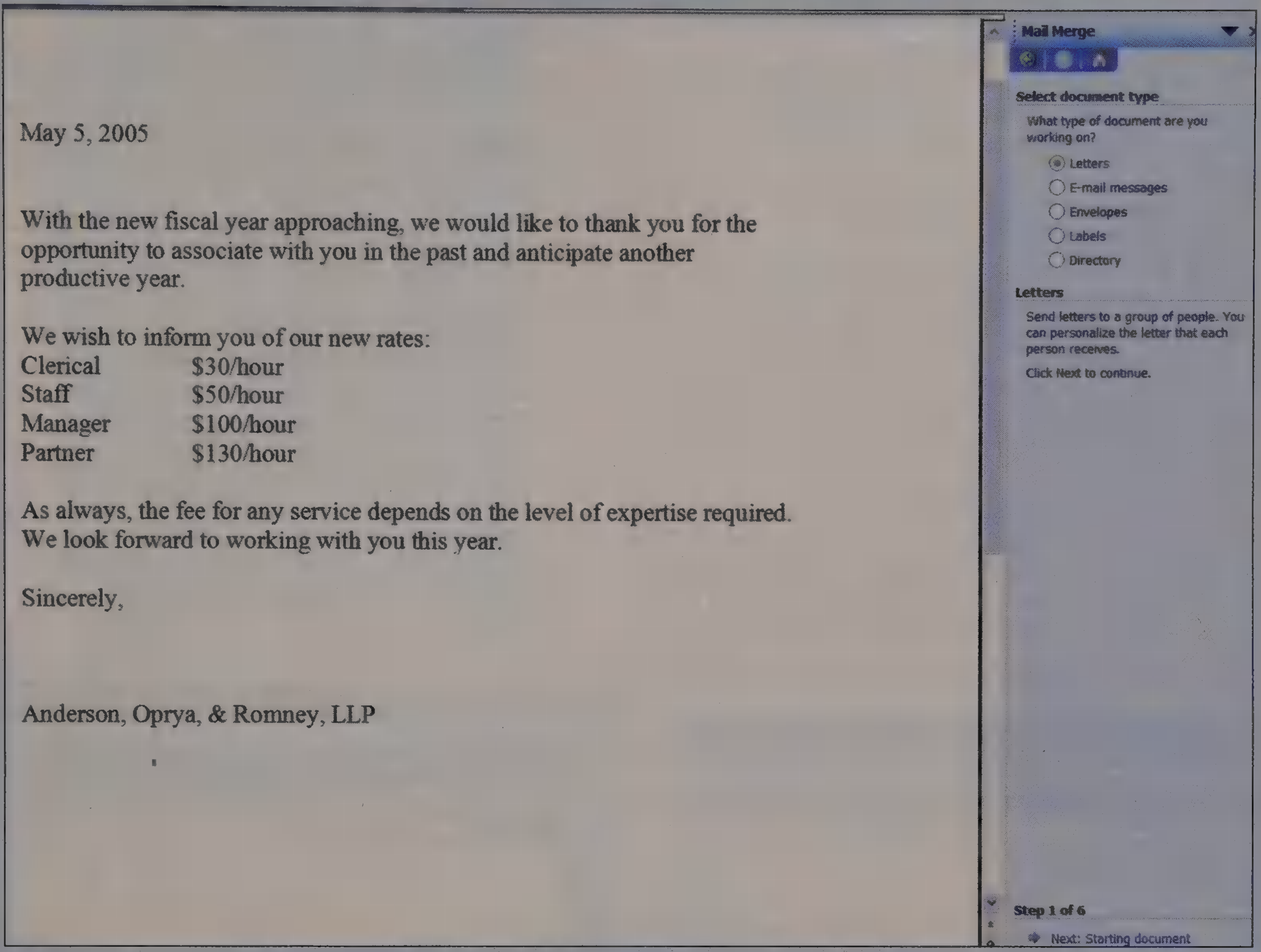


Exhibit 3

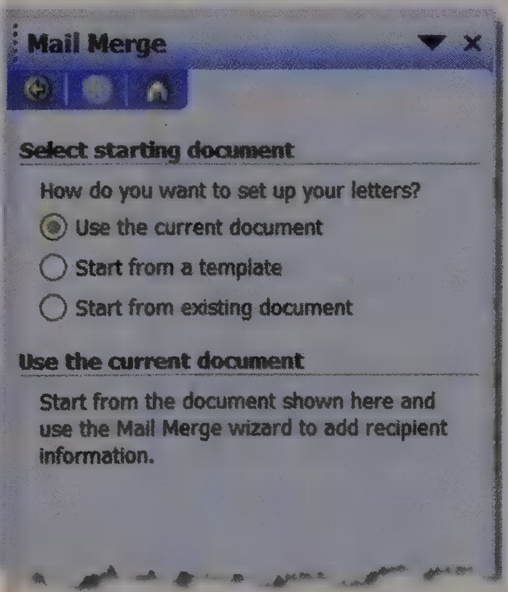


Exhibit 4

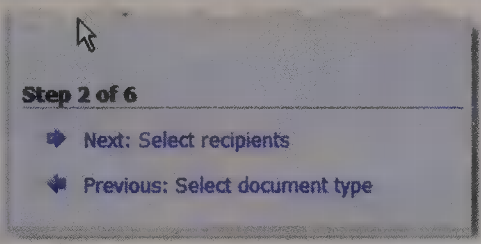
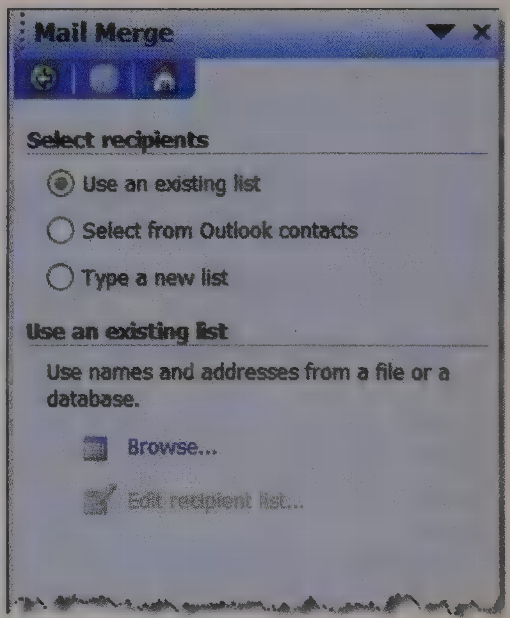


Exhibit 5



Use the current document. If you want to use a template, click on **Start from a template**. And if you already have a saved letter you want to open, edit and send, click on **Start from existing document**.

Since you do not have a letter ready, select **Use the current document** and then compose your letter.

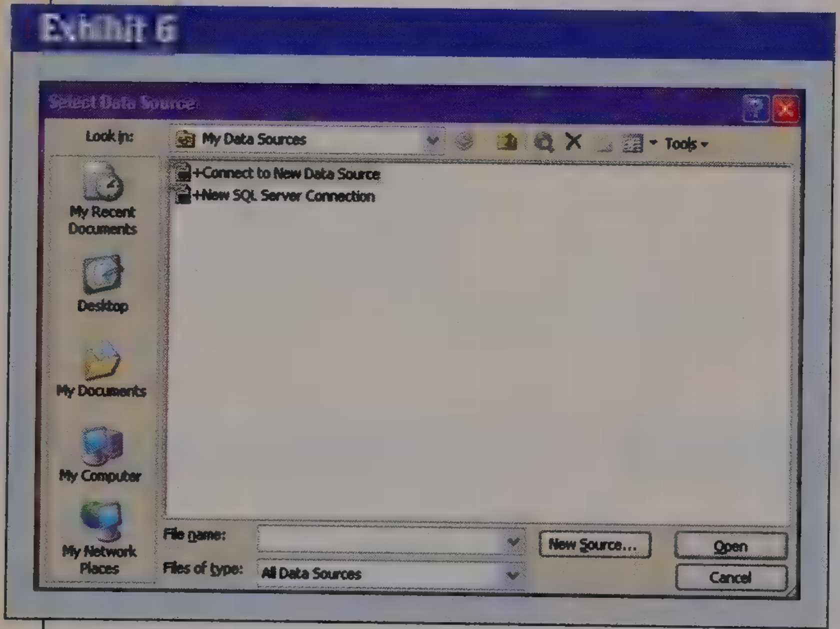
Then click on **Next: Select recipients** (exhibit 4, page 49).

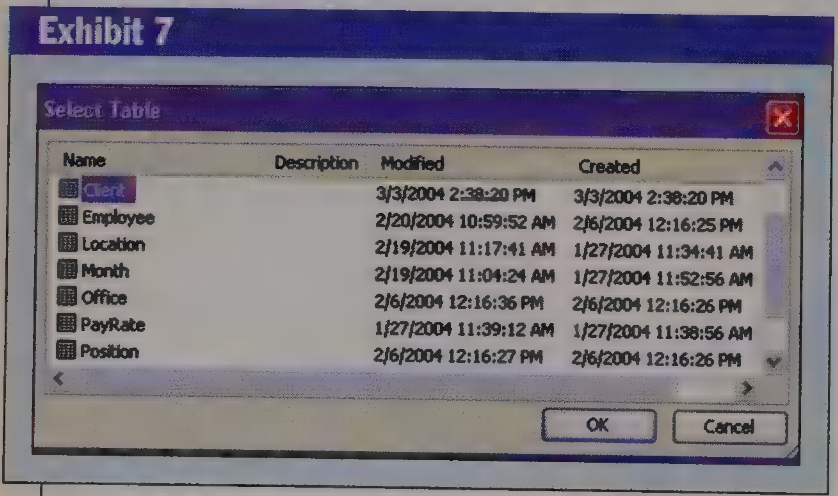
That moves you to step 3 and produces the screen shown in exhibit 5, page 49.

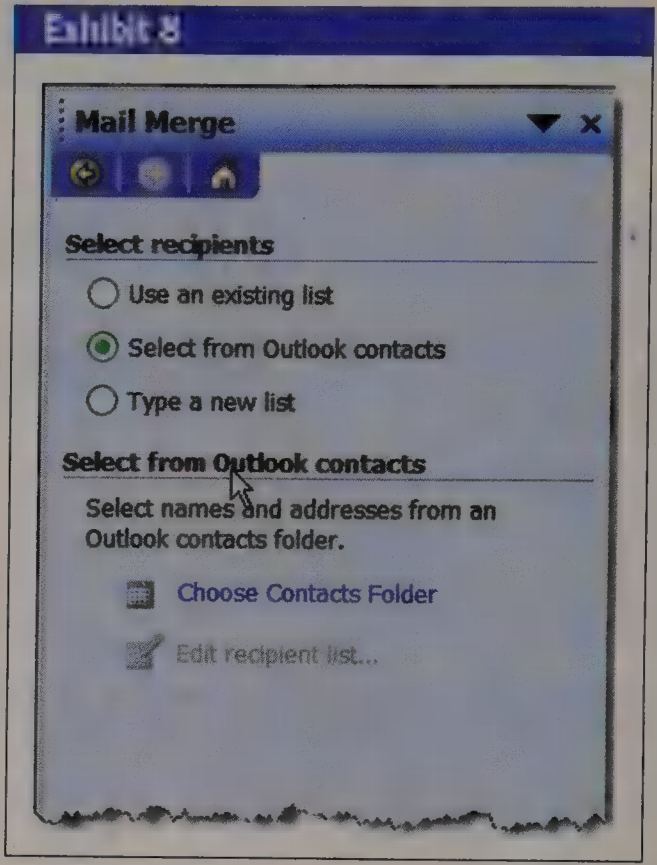
■ *Step 3:* Insert the addresses of your clients by choosing one of the first two options shown in exhibit 4, or you can type a new list (that process will be described later). In our example, since we have the information stored in an Access database table, we select **Use an existing list** under **Select recipients** and when we click on **Browse** to find the list, the **Select Data Source** screen appears (exhibit 6, below).

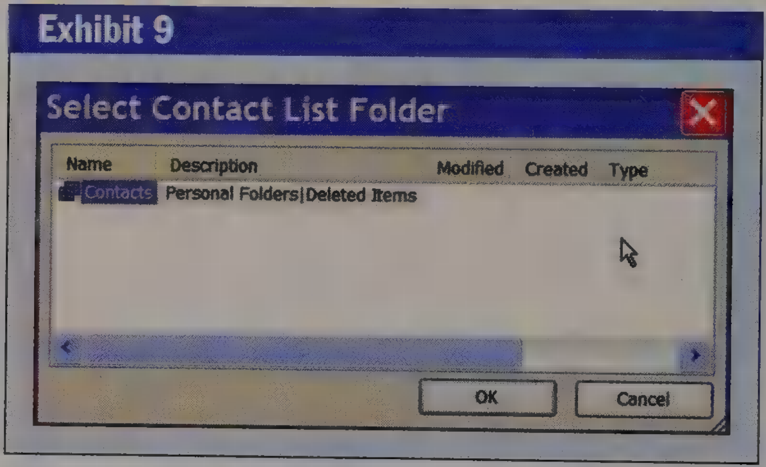
To browse through your folders for the address table, click on the down arrow next to **My Data Sources**. Find the desired database, click on it, and the **Select Table** dialog box appears (exhibit 7, below). It lists all the tables available in that database. We have highlighted the **Client** table.

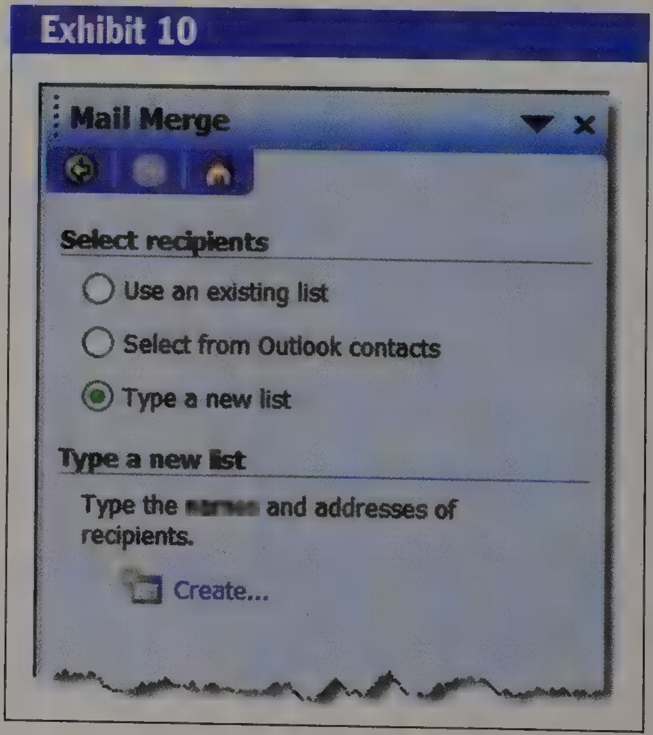
(continued on page 52)











If your client list is in **Outlook**, click **Select from Outlook contacts** (exhibit 8, page 50).

That evokes the **Select Contact List Folder** (exhibit 9, page 50).

If you wish to create a new list, click on **Type a new list** and **Create** (exhibit 10, page 50).

That brings up the **New Address List** screen (exhibit 11, below).

Fill out each client's information and click on **New Entry** for each additional entry. After entering all the names and addresses, click on **Close** and name and save your new list so you can use or edit it later.

For those readers following along using Word, please note that you will not be able to proceed to step 4 until you have at least one recipient established.

■ ***Step 4:*** Now it is time to write or edit your existing letter so click on **Next: Write your letter** (exhibit 12, below). Click on **Next** to evoke the **Mail Merge** screen (exhibit 13, at right).

Begin by clicking on **Address block** to specify the address elements. As shown in exhibit 14, below, you can choose one of many different formats for the person's name, whether to include the company *(continued on page 55)*

Exhibit 11

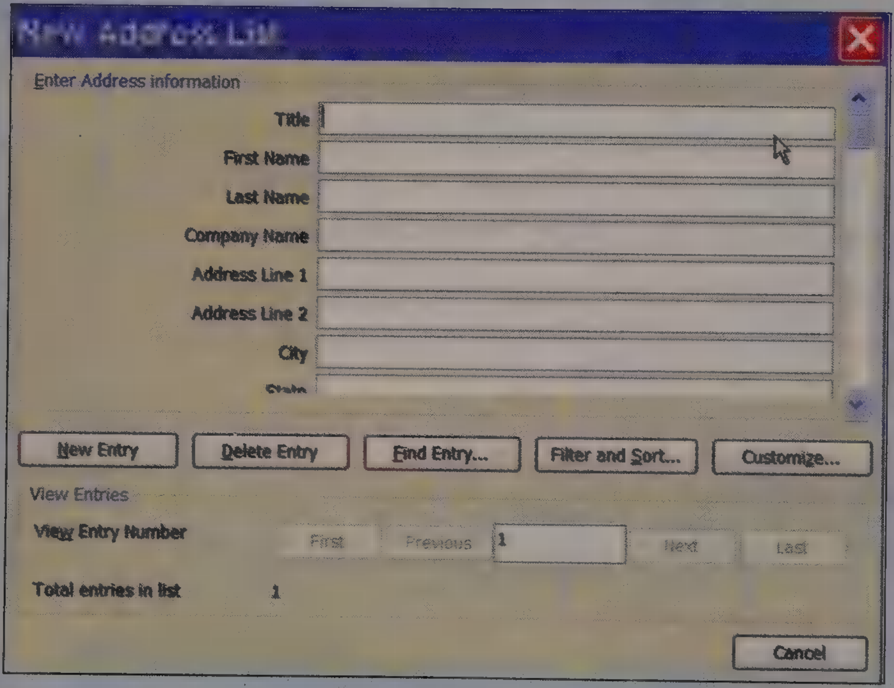


Exhibit 12

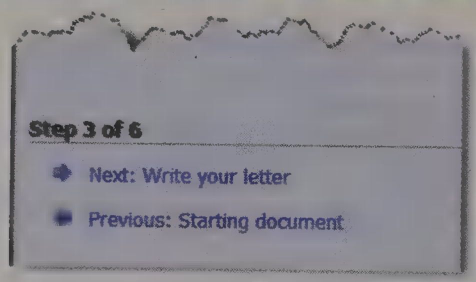


Exhibit 13

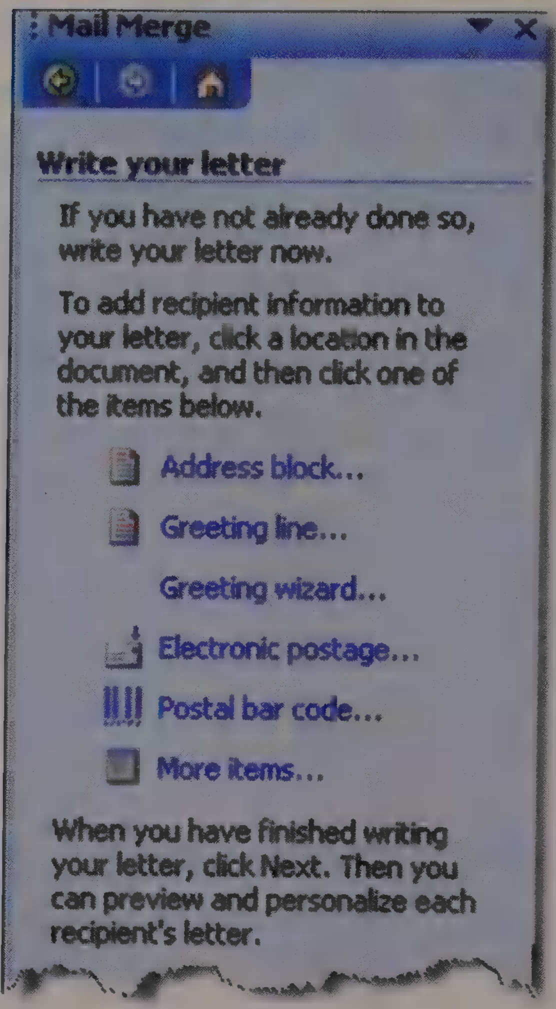
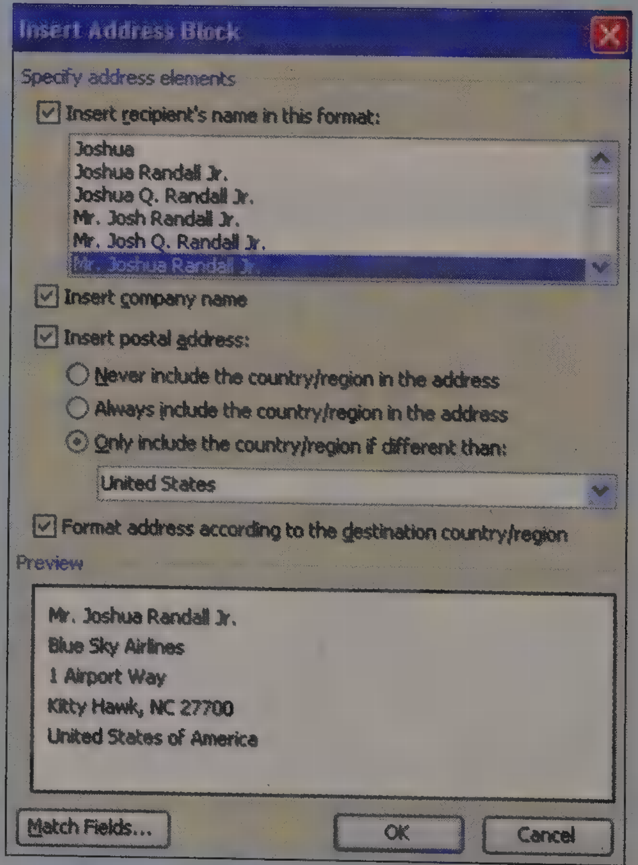


Exhibit 14




SSTI, SARBANES-OXLEY, TRANSACTION TAXES AND YOUR ERP SYSTEM:
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Exhibit 15

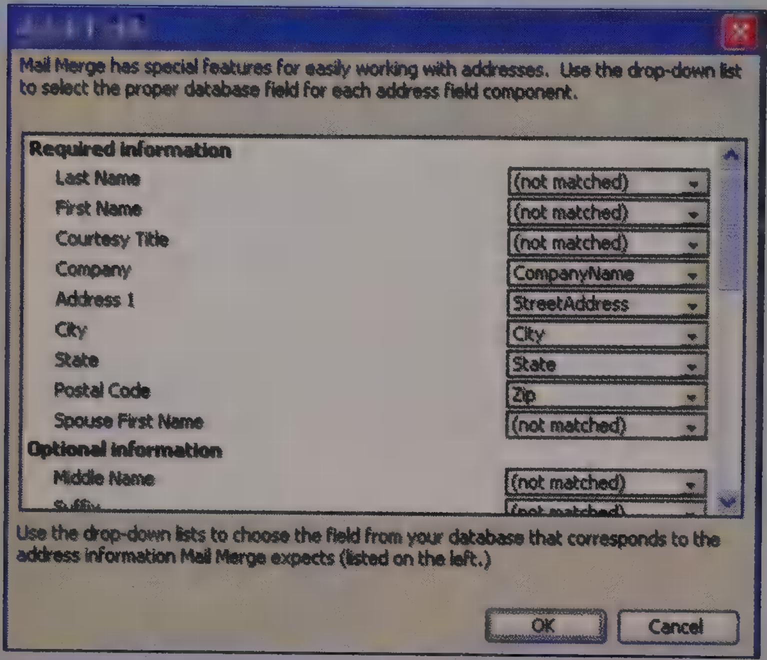


Exhibit 16

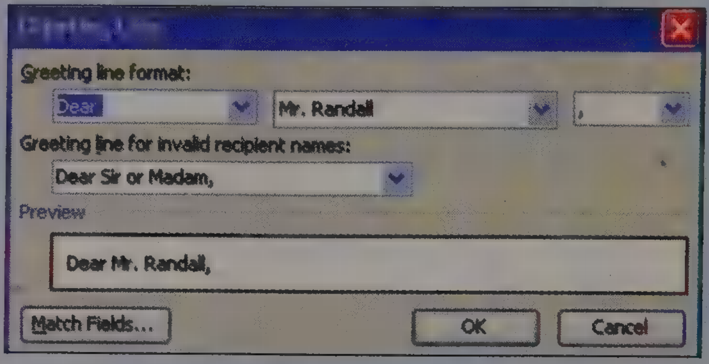


Exhibit 17

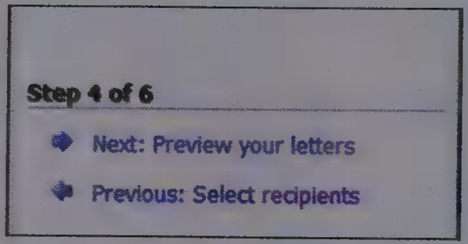
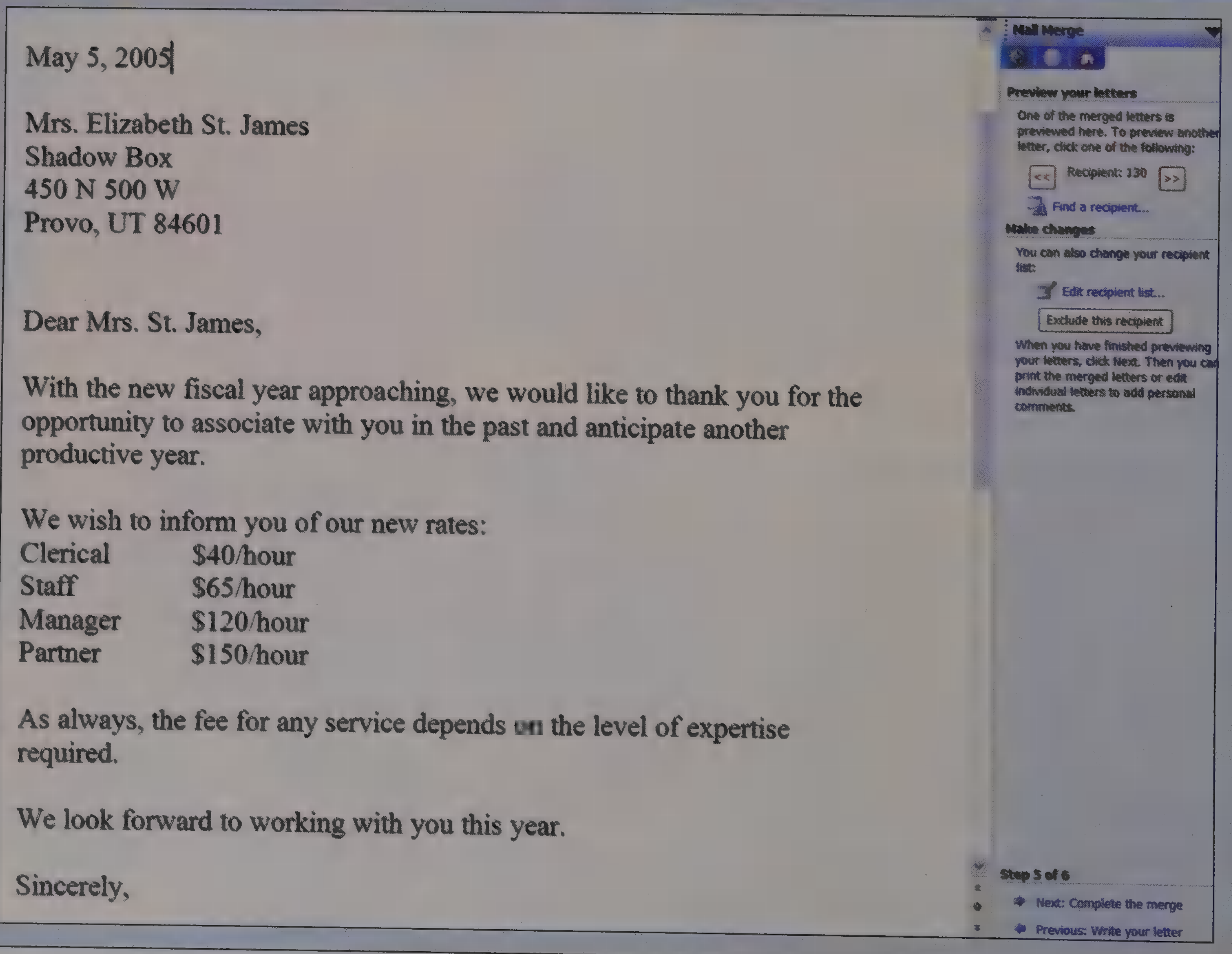


Exhibit 18



name in the address and whether to insert the postal address.

If you are using Microsoft Access, click on the **Match Fields** option (see bottom of exhibit 14). That brings up the **Match Fields** screen (exhibit 15, page 54), which requires a link for each element of information (last name and first name, for example) to its corresponding database field.

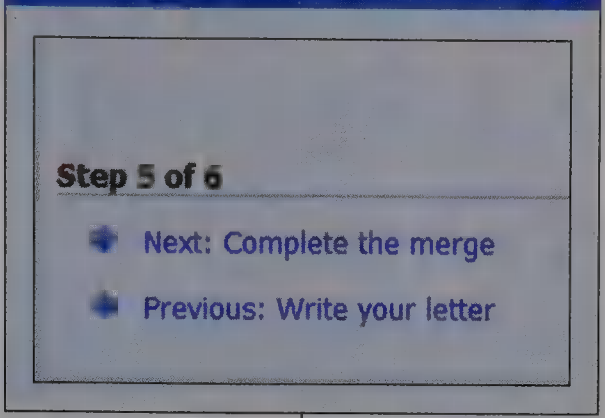
After you've matched the fields and clicked on **OK**, you're ready to add the greeting line. Go to the **Mail Merge** screen (exhibit 13) and click on **Greeting Line** to specify the greeting elements.

Fill in the requested information (exhibit 16, page 54) and click on **OK**.

Return to the **Mail Merge** screen (exhibit 17, page 54) and click on **Next: Preview your letters**. That brings up the screen shown in exhibit 18, page 54.

You now can preview each custom letter by using the back (<<) and forward (>>) arrows or by clicking on **Find a recipient**. Note in exhibit 18 that we used the arrows to display our 130th recipient. Be aware that you still can make changes to the letters, such as editing the recipient list or excluding recipients by selecting the appropriate function.

Exhibit 19



Return to the **Mail Merge** screen and click on **Next: Complete the merge** (exhibit 19, at left).

■ ***Step 5:*** At this point you can complete the merge setup, or if you wish, you can click on **Previous: Write your letter** and further edit the letters or print them.

As you can see, **Mail Merge** is a powerful tool that will save you time and money while creating professional, personalized letters. You also can use it to set up customized e-mail messages, envelopes and labels or a directory of addresses. ■

BONNIE BRINTON ANDERSON, PhD, is an assistant professor of information systems, School of Accountancy and Information Systems, Brigham Young University, Provo, Utah. Her e-mail address is bonnie_anderson@byu.edu. LARYSA V. OPYRA is a graduate student at the School of Accountancy and Information Systems. Her e-mail address is opyralv@hotmail.com. MARSHALL B. ROMNEY, CPA, PhD, CFE, is a professor of accounting and information systems at Brigham Young. His e-mail address is mbr@byu.edu.

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How to speak with professionalism and pizzazz.

Will They Throw Eggs?

BY KELLY J. WATKINS

With the advent of the Sarbanes-Oxley Act of 2002, many CPAs are required to speak at audit committee meetings and department gatherings, or even to train colleagues at various levels on the implications of the act. When it's your turn in the limelight, how will you react? Will you mumble incoherently? Will you ramble? Will a bevy of butterflies attack you? Or will you give an organized, informative presentation in a professional manner?

According to Lori Gondry, CPA, supervisor of internal audit for Kindred Healthcare in Louisville, Kentucky, "Sarbanes-Oxley is one of the biggest things to affect companies in a long time. It will force people to communicate both orally and in writing. The need to document and communicate one's role in the preparation of financial data will trickle down to the lowest levels."

Regardless of whether Sarbanes-Oxley affects you directly, it will increasingly force CPAs to do more public speaking. "Most major corporations are stressing the importance of communication skills for CPAs," says Pam Devine, customized training solutions manager for the Maryland As-

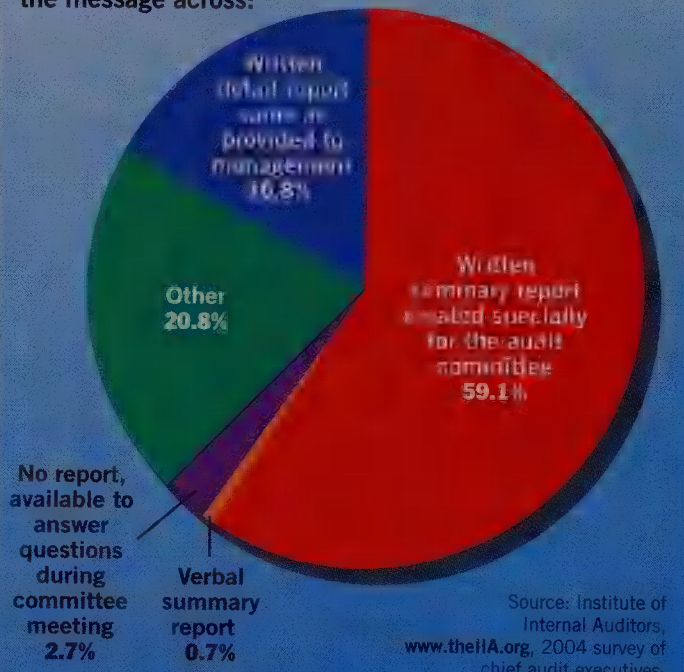
ILLUSTRATION BY JANET STREET/IMAGES.COM

sociation of CPAs in Towson. "Almost every one of our corporate clients is considering offering a communications course this year."

CPAs are expected to convey financial information or reporting requirements in an organized and professional manner. Your ability to communicate will have a direct impact on how others perceive you—and your expertise as a CPA. This article explains how to organize effective presentations for a wide variety of technical and nontechnical audiences.

How Internal Audit Communicates With the Audit Committee

As Sarbanes-Oxley changes how executives and managers communicate with the board of directors, a 2004 survey showed the methods auditors use to get the message across:



Source: Institute of Internal Auditors, **www.theIIA.org**, 2004 survey of chief audit executives.

ACHIEVE MAXIMUM IMPACT

To have the biggest effect, a presentation must be well-written and well-organized. Devine says, "If speakers aren't organized, listeners may begin to question the numbers they're presenting." Writing in an organized fashion requires only a little preliminary effort. CPAs can use the following methodology to write either a formal presentation or a two-minute staff report. Although this process may seem cumbersome at first glance, it actually will save time in the end.

STEP ONE: Brainstorm. The first step is to think. Write down everything you might want to cover on the subject until you've exhausted all ideas. It's OK to abbreviate at this point. Avoid the temptation to just start writing the presentation. You'll end up with a jumbled mess.

STEP TWO: Select headings. Determine how you'll organize the presentation—how you will divide it. What headings will you use? If you're speaking on Sarbanes-Oxley to a group that's unfamiliar with it, for example, you might use headings such as:

I. Explanations of Sarbanes-Oxley.
II. Implications for your department.
III. What you need to do differently now.
IV. Preparing for the future.

STEP THREE: Assign items. Review the information on the brainstorm sheet. Assign each item to one of the headings. If you have information that doesn't seem to fit anywhere, omit it.

STEP FOUR: Outline. Put everything into a basic outline (nothing as elaborate as your senior English teacher required). A flowchart will work, too. An outline forces you to get organized and keeps you from randomly throwing in concepts. You can also see at a glance whether the headings are lopsided. If there are too many points under one heading, you may be spending too much time on that area.

STEP FIVE: Add transitions. After the outline is complete, add the necessary transitions so things make sense. These are little key words and phrases that connect all the points

EXECUTIVE SUMMARY

- **TO MEET THE REQUIREMENTS OF SARBANES-OXLEY,** CPAs are making more oral and written presentations than ever before to more diverse groups, including audit committees and department gatherings. CPAs' ability to communicate will have an impact on how others perceive them and their expertise. A well-organized presentation makes all the difference.

- **TO WRITE AN EFFECTIVE PRESENTATION,** CPAs can follow five steps: Brainstorm, select headings, assign items to one of the headings, create an outline and add transitions so things make sense.

- **SINCE AUDIENCES INCLUDE PEOPLE WITH DIFFERENT** levels of expertise who need to know different amounts of information, it's critical to know your audience when you develop a presentation. When addressing a nontechnical group, make the necessary adjustments to ensure they understand.

- **WHILE POWERPOINT CAN BE AN EFFECTIVE TOOL,** CPAs should not depend on it too much. The slides should not dominate the presentation.

- **TO HANDLE AUDIENCE QUESTIONS WITH EASE,** speakers should try to anticipate what they may ask and prepare answers ahead of time. They also should repeat each question before answering to gain a few seconds to think. When they don't know an answer, they should say so, then look it up and send it to the group after the presentation.

KELLY J. WATKINS is an international speaker and author on communication topics. She can be reached at **www.keepcustomers.com** or by e-mail at kelly@keepcustomers.com.

together. Numbers work great. For example, "There are four reasons why Sarbanes-Oxley is relevant to your department. First,…Second,…"

Ordinal numbers also serve to provide a road map for listeners. They're similar to chapter headings in a book and they tell listeners (who can't go back and "reread" something if they get lost) where you are in the presentation.

KNOW THE AUDIENCE

Any audience—from audit committees to colleagues to volunteer boards to your local parent–teacher organization—includes different types of people who need to know different types (and amounts) of information. According to Mary McKinley, CPA, senior manager at BKD, an accounting firm in Louisville, Kentucky, "Knowing your audience is critical. Speakers should tailor language and content to each group." When planning a presentation, put yourself in the attendees' shoes. What information do they need or want?

As CPAs, you're in the numbers business. You're in the details business. But many of your audience members aren't. Sometimes they want only an overview, sometimes the opposite is true. McKinley tells of a training session she attended at which the attendees were eager for in-depth information, but the speaker spent all his time explaining broad concepts they already knew. His presentation failed because he hadn't researched his audience.

Pam Devine, training manager for the Maryland Association of CPAs, says major corporations increasingly are stressing the importance of communication skills for CPAs.

PHOTOGRAPH BY DENNIS BRACK/BLACK STAR

ACCOMMODATE NONTECHNICAL AUDIENCES

As a CPA, you may find yourself in situations where you must address audiences that aren't financially savvy or familiar with technical accounting concepts. In these cases, it becomes your job to assume the role of teacher.

Dale Gettelfinger, CPA, president of CPAmerica affiliate Monroe Shine in New Albany, Indiana, recalls attending an audit meeting where the audit team manager launched into a technical response that was not really on point. The group felt the manager was being evasive. "Too often CPAs resort to jargon or an involved technical response, thinking it is a time-saver," he says. "This is only true when everyone knows and understands the issues."

How do you avoid hiding behind jargon? As you review the technical terms you'll use in the presentation, think about Gettelfinger's comment. Will everyone understand the issues? What might they find confusing?

It's difficult to educate people without appearing condescending. Provide a brief explanation of the item but don't draw attention to it. Simply provide the definition as part of the presentation. When you're subtle, people won't feel you're talking down to them.

AICPA RESOURCES

- The author has developed a new CPE course, "Talking, Listening, Writing, and Presenting," which is available at **www.AICPAlearning.org**. (This article is based on the Presenting module.) Watkins also has several online CPE courses available via InfoBytes at **www.cpa2biz.com**.
- AICPA Audit Committee Effectiveness Center and the Audit Committee Toolkit, **www.aicpa.org/audcommctr**. A variety of resources created to help audit committees and those who work with them execute their responsibilities.

CREATE EFFECTIVE POWERPOINT PRESENTATIONS

One of the biggest mistakes speakers make is relying too much on their PowerPoint graphics. You are the speaker; you are the expert. The slides are simply an educational tool. Don't let PowerPoint *become* the presentation.

Here are five tips to help you create more effective PowerPoint slides.

(continued on page 60)

- Less is more. Use fewer slides and put less information on each. If you're presenting complex financial data, give the audience a handout. (*Caveat*: Don't give the audience any extensive reading material until after the presentation or everyone will focus on it and not on you.)
- Slides are for emphasis. They should reinforce your main points or illustrate complicated issues.
- Use a graph or chart to illustrate general trends or give a big-picture view. Put the detailed numbers in a handout. Make sure the audience can see the labels/headings inside the graph.
- If you need to discuss a certain line item, put just that item on the slide, not the entire spreadsheet.
- If you must put several numbers on the screen at once (and there is almost no time when that's truly required), highlight the specific number you're discussing by making it larger. Continue to do the same for other numbers you want to focus on.

Mary McKinley, a CPA in Louisville, Kentucky, says it's critical for CPAs to know their audience and tailor language and presentation content accordingly.

PHOTOGRAPH BY KEN HAYDEN/BLACK STAR

REDUCE NERVOUSNESS

The best way to appear confident in front of an audience is to be prepared. Avoid the temptation to wing it; the audience will know if you do. According to Gettelfinger, "I know firsthand how challenging it is to take the time to prepare everyone for an effective meeting. But better preparation means better meetings."

Make the time spent preparing proportional to the importance of the speech. A three-minute informal update at a department meeting requires much less practice than a 45-minute annual presentation to the audit committee.

Practice aloud. Giving the speech in your head doesn't count. If possible, visit the room where you'll be speaking in advance and do a dry run of the speech. Having a mental picture of the setting will make you feel more comfortable.

Five Tips to Overcome Last-Minute Jitters

1. ***Arrive early.*** You won't appear very calm if you come running into the room at the last minute and leap into your chair with perspiration pouring down your face.
2. ***Check the equipment.*** Is the LCD projector hooked up? Do the markers by the flipchart write? Don't let someone else demonstrate how to turn the equipment on or how to adjust it. You'll be the one doing it during the presentation, so practice.
3. ***If possible, pre-set materials.*** Place notes on the lectern or table. Load the PowerPoint file and have it ready. Put any supplemental materials within easy reach. If that isn't possible, keep your materials together in front of you so you don't have to dig for them when it's your turn to speak.
4. ***Be alert while being introduced.*** The group is looking at you, not the person introducing you. This is not the time to tug at your skirt or adjust your tie.
5. ***Make eye contact.*** Take a deep breath, look out at the group and *smile*.

HANDLE QUESTIONS WITH EASE

Answering questions can be nerve-racking. I discovered this firsthand when giving a seminar on presentation skills to a group of about 150 people in Venice, Italy. During the question-and-answer session, a woman raised her hand. When I called on her, she said in a loud, clear voice, "You mentioned clothing. Well, I'd never wear what you're wearing."

Apparently, the color of my suit was a little too bright for her taste. I turned the question to my advantage and replied, "That's an interesting observation. As I said earlier, when you're speaking internationally, it's important to remember cultural issues for *dress*, as well as for content." (Now that I survived the incident, it makes a great story!)

Why is it important to handle questions effectively? Gettelfinger recalls a situation in which two young staff auditors were asked a question by an audit committee. They were caught off guard and got defensive. They even tried to convince the audit committee its question was immaterial.

How did this affect Gettelfinger's perception of the auditors? "I felt the engagement partner was out of touch with the engagement," he says, "and the other auditors didn't genuinely care about the future of our organization." Ouch!

Here are several techniques to help you avoid that negative appearance and handle questions in a professional manner.

Put the experience in perspective. Your job is to make the audience understand the material you're presenting. That means listeners should ask you questions until they fully comprehend the information. Recognize the audience is just doing its job; this isn't a personal attack.

Prepare for questions. What are the five most difficult questions they could ask? What are the five areas you have the most difficulty explaining? Prepare answers. Write them out. Practice saying them aloud. Now you're ready for the worst and everything else will seem easier.

Repeat the question. This allows your brain a few seconds to think while your mouth goes on auto-pilot to repeat the question. It also ensures everyone in the room heard the question.

Behave professionally when you don't know the answer. Don't ramble or dance around the subject. And don't resort to technical mumbo jumbo. You'll appear more professional if you simply admit you don't know the answer. Then assure the group you'll find the solution and send it to them immediately.

CPAs often resort to using jargon or an involved technical response, thinking it will save time, says Dale Gettelfinger, CPA, of Monroe Shine in New Albany, Indiana.

PHOTOGRAPH BY KEN HAYDEN/BLACK STAR

A PROFESSIONAL IMAGE

It's ironic that a technical law (Sarbanes-Oxley) is what has finally caused corporations to realize they need to improve nontechnical communications skills. As making effective presentations becomes an even more critical part of their careers, CPAs should expend the time and effort necessary to create and deliver speeches that convey a credible and professional image. Whenever you speak to a group, your reputation as a CPA is at stake. By implementing the techniques discussed here you can be confident your presentation will sparkle with polish and pizzazz. ■

PRACTICAL TIPS TO REMEMBER

- The first step in putting together an effective presentation is to write down everything you think you might want to cover on the subject. Then use this information to develop the presentation.
- Know your audience and tailor the presentation accordingly. If necessary, accommodate for nontechnical audiences by defining unfamiliar terms as you speak.
- Slides are for emphasis. Don't let PowerPoint *become* your presentation. Put less information on each slide and use fewer slides. Put complex financial data on a handout and distribute it to attendees after the presentation.
- Prepare for questions in advance by asking yourself: What are the five most difficult questions they could ask? Write out prepared answers and practice saying them aloud. During the presentation, repeat each question to give your brain a few seconds to think before you start your answer.

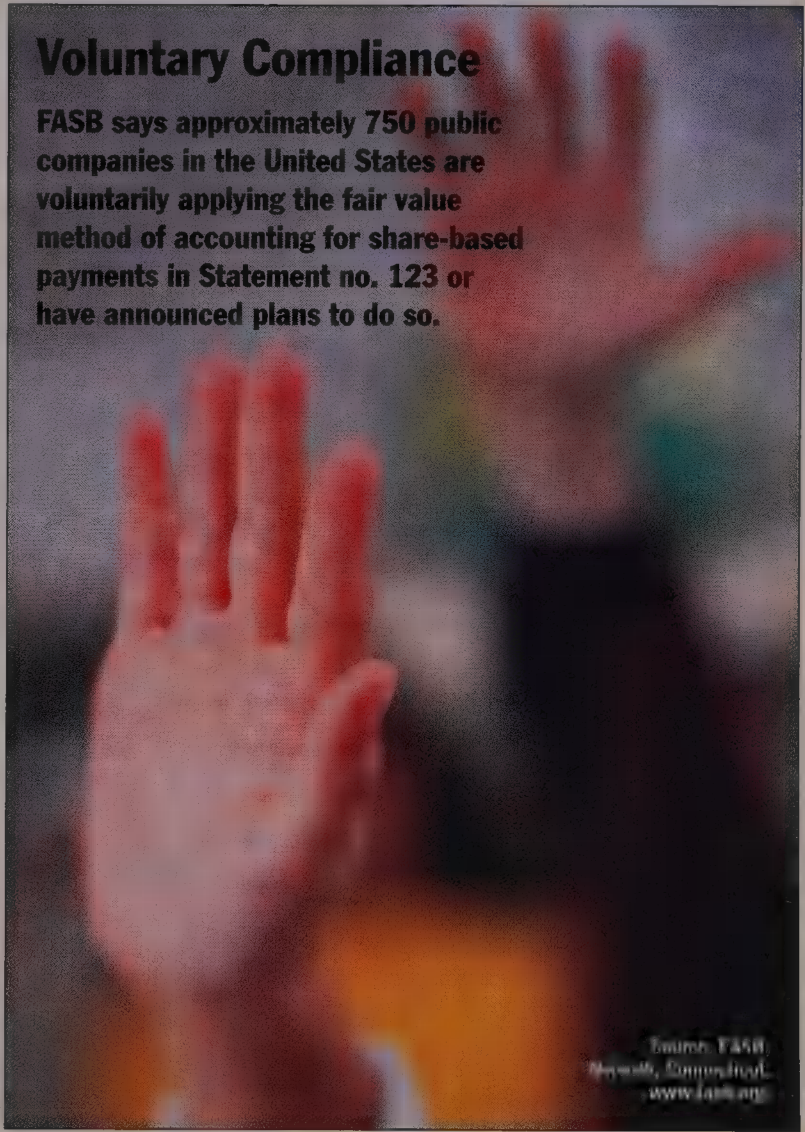
FASB mandates how companies should account for share-based compensation.

No Longer an "Option"

BY TIM V. EATON AND BRIAN R. PRUCYK

The controversy over accounting for stock options and similar compensation continues. While the wounds from the fight over FASB Statement no. 123 a decade ago are still healing, FASB issued a revised standard, Statement no. 123(R), *Share-Based Payment*, in December 2004. The board said its goal was to provide investors and other financial statement users with more complete and neutral information by requiring companies to recognize the compensation cost related to share-based transactions in their financial statements.

Initial reaction to the standard shows the debate over the best way to account for share-based compensation has not been fully resolved. Congress, corporations and individuals have voiced strong concerns about the new rule. In September 2004, the FASB Web site listed over 6,500 comment letters on the exposure draft for Statement no. 123(R); a typical ED generates fewer than 100. CPAs will find the revised standard will have long-term implications for their clients or employers. This article explains the important details of the statement and offers CPAs some suggestions for implementing its provisions.



PHOTOGRAPH BY GABE PALMER/CORBIS

A BRIEF HISTORY OF STOCK OPTION ACCOUNTING

In 1972, the Accounting Principles Board issued Opinion no. 25, *Accounting for Stock Issued to Employees*. It used an *intrinsic value method* of valuing stock compensation. The basic methodology involved calculating the difference between the market price of the underlying stock and the exercise price of the options on the date the company granted them. For example, an option to purchase a share of stock with a market price of $50 on the grant date and an exercise price of $40 would have an intrinsic value of $10. This method allowed companies to recognize no compensation cost assuming they met certain criteria. Although issued more than 30 years ago,

Glossary of Key Terms

Binomial model. A lattice model (see below) where the asset price can change to only one of two possible values in the next time period.

Black-Scholes-Merton model. A specific closed-form valuation model for options that cannot be exercised prior to maturity.

Closed-form valuation model. A model where an estimated fair value can be calculated by plugging numbers into an equation.

Expected volatility. The expected fluctuation in the price of a share of stock over the period for which a company is valuing an option. It usually is measured as the standard deviation of expected continuously compounded rates of return on the stock.

Fair value. The amount at which an asset (or liability) could be bought or sold (or settled) in a current transaction between willing parties.

Intrinsic value. A value determined by taking the fair value of the underlying security and subtracting the exercise price of its corresponding option.

Lattice valuation model. A model where the asset price can take on only a discrete number of values in the next period. The derivative security is valued based on these asset prices by recursively working back through the model from the derivative's final maturity.

Option pricing model. A valuation technique based on established principles of financial economic theory to estimate the fair value of employee stock options and similar instruments.

until very recently most companies chose to continue following Opinion no. 25 for financial reporting purposes.

The genesis of the new standard goes back to 1993 when FASB issued an ED on stock-based compensation that changed the emphasis from the intrinsic to the *fair value method* of valuing stock options. Under this approach the option value (and related compensation expense) was based on the market price of an option with the same or similar terms (when available) or estimated using an option pricing model (applicable to most companies). The option we referred to above that had an intrinsic value of $10 would have a fair value of $18.34, using the Black-Scholes-Merton Model discussed in detail below.

Under tremendous pressure, FASB issued Statement no. 123 in 1995. It encouraged but did not mandate companies' use of the fair value method to determine compensation expense on the income statement. As a result of having this option, most companies continued to use the intrinsic value method to report compensation expense.

In 2003, members of Congress developed the Stock Option Accounting Reform Act, which would challenge FASB and mandate how companies should account for share-based compensation. To date no legislation has passed. In the midst of the controversy FASB issued Statement no. 123(R) late last year. (See "Official Releases," page 91.)

THE REQUIREMENTS

Statement no. 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. Some of its key requirements include

■ Companies are required to use the fair value method to value options and other share-based payments. This

EXECUTIVE SUMMARY

■ **IN DECEMBER 2004, FASB ISSUED ITS NEWEST** standard, Statement no. 123(R), *Share-Based Payment*. It is proving to be as controversial as its predecessors. The most significant change is the requirement that companies use the fair value method to account for share-based compensation.

■ **STATEMENT NO. 123(R) ELIMINATES THE USE** of the intrinsic value method of accounting for share-based payments under APB Opinion no. 25. Many companies had continued to follow it even after FASB issued Statement no. 123 in 1995.

■ **TO FOLLOW THE FAIR VALUE METHOD,** most companies will have to use an option-pricing model to estimate the fair value of employee share options. There are several methodologies to choose from, including a closed form model or a lattice model. Most companies that currently use the fair value method use Black-Scholes-Merton, a closed-form model.

■ **ALL MODELS RELY ON A NUMBER OF ESTIMATED** items—including the exercise price of the option, its term, the current market price of each share of underlying stock, expected volatility and dividends and the risk-free interest rate—that can greatly influence the fair value of share-based compensation.

■ **CPAs CAN EASILY CHOOSE SEVERAL MODEL** components while others are more complex and rely on forward-looking information. Companies can begin by examining historic information but should make appropriate adjustments to reflect the future.

TIM V. EATON, CPA, PhD, is associate professor of accounting at Marquette University in Milwaukee. His e-mail address is tim.eaton@marquette.edu. BRIAN R. PRUCYK, PhD, is assistant professor of finance at Marquette University. His e-mail address is brian.prucyk@marquette.edu.

means they will recognize compensation cost based on the fair value of equity instruments issued for employee services on the grant date.

- This valuation should be based on the observable market price, when available, of an instrument with the same or similar terms.
- Since such a valuation usually is not available for most share-based payments, FASB recognizes that most companies will use an option pricing model to estimate the value.
- FASB does not require a specific option pricing model. However, any model a company uses must incorporate a variety of factors, including the exercise price of the option, the term of the option, the current market price of each share of underlying stock, expected volatility and dividends and the risk-free interest rate.
- Once estimated, the company should recognize the determined compensation cost over the period in which an employee provides service to receive the award (known as the requisite service period).
- Public companies must use fair value to measure liabilities in share-based payment transactions. Nonpublic companies, however, may use intrinsic value.

The statement also requires certain disclosures to help financial statement users. These include the details of any share-based compensation arrangements the company offers, their effect on compensation cost on the financial statements and what methodology the company used to estimate the fair value.

Effective dates. Most public companies must implement the new rules as of the start of reporting periods beginning after June 15, 2005. Public entities that file as small business issuers and nonpublic companies have extra time; they must apply Statement no. 123(R) for the first annual reporting period after December 15, 2005.

HOW TO IMPLEMENT THE STATEMENT

In addition to knowing the basic requirements of the new standard, CPAs must familiarize themselves with some important technical terms. These are listed in a glossary on page 64. For most companies the next step will be to decide which option pricing model to use. In making this decision CPAs should understand that employee share options differ from the usual exchange-traded options most models were developed to value in a number of ways. The most notable are that the employee options are nontradable and must be used exclusively by the individual to whom they were granted.

The choice of which model to use is a critical decision for CPAs and their employers or clients. FASB discusses two basic models—closed-form and lattice. Each has its

own advantages and disadvantages. The most common closed-form model is Black-Scholes-Merton; companies may wish to use it precisely because it is the most common option pricing model in practice today. Besides providing greater comparability with other companies that also employ it, it is easier to apply because it is a defined equation. (See "Black-Scholes-Merton at a Glance," page 68.) CPAs also easily integrate the model into a spreadsheet. Black-Scholes is an acceptable method according to Statement no. 123(R).

Some CPAs may feel a lattice-type model is a better choice for their companies. In fact, FASB originally recommended the lattice model as preferable but backed down after receiving public comment. The most common lattice model is a binomial one. Although companies use it less frequently, some argue the binomial model provides more accurate estimates of option compensation expense because it can take into account more assumptions (early exercise behavior) than Black-Scholes and can incorporate multiple inputs (volatilities), whereas Black-Scholes can

CASE STUDY

Scotts Co. Grows Into Good Governance

It was back in 2002, in the course of long discussions about good governance and financial transparency, that Chris Nagel, CPA, CFO of the Scotts Co., and his CEO decided to start expensing stock options. The board of directors and the audit committee of the Marysville, Ohio-based company—the world's largest manufacturer of horticultural products—agreed. And honestly, Nagel acknowledges, he thought every company soon would follow suit. "We took a reading of the tea leaves and thought this was the way the world was headed," he says. "We wanted to show our investors we were trying to be transparent." So Scotts took a hit for the third of its outstanding stock options that come due each year, charging about $5 million—roughly 3% of its $160 million pretax earnings—against its 2003 P&L. For 2005, accounting for all stock options will mean expensing $12 million on pretax earnings of $250 million, or about 5%, Nagel estimates.

The world did eventually catch up. With FASB Statement no. 123(R) on the horizon, Nagel shared his thoughts about his three-year odyssey into expensing stock options with JofA *managing editor Cheryl Rosen.*

It's your third year of expensing options. What are you doing differently?

We had adopted Black-Scholes, but now believe binomial is the appropriate model for valuing options. A lattice or binomial model offers some improvement over Black-Scholes. To value options, you have to make assumptions about the likely term and volatility, and I think a lattice model captures those variables better. Luckily I'm not the guy who has to grind through the numbers.

Are you rethinking the whole idea of offering stock options as an employee benefit?

No, we still think options are a valuable tool for employee compensation. But we'll be using a combination of restricted stock and stock options. With stock options, if the stock price goes down, the owner hasn't really lost anything—the focus is entirely on the up side. We've seen that lead to abuses at many companies as they tried to manipulate earnings. So now our idea is to offer a combination of options and restricted stock. That better aligns the goals of our employees with those of our shareholders, because if the stock goes down, the shareholders are not really indifferent. They are really losing value and with restricted stock, so are our employees. As part of his or her overall compensation, an employee might earn X in base pay and X in options. If we're

PHOTOGRAPH BY MIKE FOLEY/BLACK STAR

Scotts Co. CFO Chris Nagel, CPA, says expensing stock options early was the right thing for the company to do. It still hits its growth target in 2003 even with the charge to earnings, and the pain of adopting Statement no. 123(R) is behind it.

only incorporate one set of inputs. However, these same characteristics also make it more complex. In fact, some companies may not have staff with the technical expertise necessary to integrate a binomial model into their option pricing activities.

Once they have selected a model and begin to make the transition to the new standard there are some practical tips CPAs should consider.

■ Valuing compensation expense is not simply a matter of plugging the "right" numbers into a model. Many of the components are quite complex and involve forward-looking information. While historic information can be a good starting point and may be a reasonable indicator of what to expect, companies should not rely on it alone. Instead CPAs should make appropriate adjustments based on a company's future.

■ In calculating meaningful estimates of option value it's very important to use a consistent verifiable method to estimate the parameters of any valuation model. The approach a company uses should account for most of the factors that

going to give $100,000 in option value, we can plug that into Black-Scholes and figure out how many options that is, or we can divide it by our current stock price and just give a number of shares. It's unlikely to change the ultimate charge on our books, but it changes the employee's focus. I think a combination of the two will produce the right balance.

Are you glad Scotts took a lead position on expensing options?

Being an early adopter put a burden on our P&L, but it was the right thing to do. I don't think the market reacted one way or the other to our story—we hit our earnings growth target in 2003 even with the charge. I'm not sure we got any credit for good corporate governance. But every company's major concern has to be the investor perspective, and we hope we did get credit in the minds of investors; we have no way to measure that. Next year will be nice, though, because the pain of adoption already will be behind us.

Any advice for your fellow CPAs implementing Statement no. 123(R) for the first time?

I suspect that in the first year companies will present pro forma earnings with and without the charge. But as they ramp this up over some vesting period I can't imagine that many will be able to ask investors to accept this as a reason for lower earnings over three or four or five years. You have to view it as a cost you have to manage. You just have to accept it.

FASB may need to address the lack of comparability by requiring companies to use a specific option pricing model.

have an impact on the input being estimated. For example, in estimating the weighted-average-life of an option using the Black-Scholes-Merton model, CPAs should explicitly account for any period over which the option cannot be exercised and for any predictable employee exercise patterns of which they are aware.

■ The length of time over which a company computes share price returns can play a significant role in the expected volatility input to the model. For example, companies can use daily, weekly or monthly prices in calculating returns. In most cases the shorter the time period the returns are measured over, the higher the resulting volatility estimate. When estimating the value of an option with an extended time to maturity, CPAs should recommend a longer measurement period (monthly) to produce more consistent results.

Black-Scholes-Merton at a Glance

Black-Scholes-Merton is a closed-form model CPAs can use to value options on assets whose volatility is constant over time and which have a constant dividend yield and risk-free rate. It requires these inputs for valuation: (Example numbers provided are for illustration purposes only)

- Current stock price (S), as an example $50.
- Exercise price (X), for example $40.
- Expected time to maturity (T), for example 4 years.
- Risk-free rate (r_f), for example 3.5%.
- Dividend yield (d_y), for example 1.5%.
- Expected volatility of the stock price (σ), for example 35%.
- N() the cumulative normal density function which assigns the probability of a given number falling at or below a given value.
- *e* is the base of a natural logarithm defined as 2.7182818.

Using this formula the Black-Scholes value of a call option can be written as

$$C = Se^{-d_y T}N(d1) - Xe^{-r_f T}N(d2) \text{ and } d1 = \frac{\ln\left(\frac{S}{X}\right) + \left(r_f - d_y + \frac{\sigma^2}{2}\right)T}{\sigma\sqrt{T}} \text{ and } d2 = d1 - \sigma\sqrt{T}$$

Substituting the numbers from the example:

$$d1 = \frac{\ln\left(\frac{\$50}{\$40}\right) + \left(0.035 - 0.015 + \frac{0.35^2}{2}\right)4}{0.35\sqrt{4}} = 0.7831 \text{ and } d2 = 0.7831 - 0.35\sqrt{4} = 0.0831$$

$$N(.7831) = 0.7832,\ N(0.0831) = 0.5331$$

$$C = \$50e^{-0.015*4}0.7832 - \$40e^{-0.035*4-0.015*4}0.5331 = \$18.34$$

Thus the option in this example has a value of $18.34.

UNRESOLVED ISSUES

The new standard does not answer all of the questions about share-based compensation. Statement no. 123(R) still permits companies to choose which option pricing model they use. Different ones produce different levels of compensation expense. FASB may need to address this lack of comparability by requiring companies to use a specific model. Another concern is that within each model companies can use various estimates based on expectations. As each estimate changes, the compensation expense can vary greatly. FASB will continue to gather feedback from the accounting profession, Congress and the public, making it unlikely the controversy over accounting for share-based compensation will go away anytime soon. ■

PRACTICAL TIPS TO REMEMBER

- Statement nos. 123 and 123(R) include some new terminology CPAs should know as they begin to implement the requirements of accounting for share-based compensation.
- Many of the models companies use to value share-based compensation arrangements are complex and require CPAs to input forward-looking information. While historic information can be a good starting point, without appropriate adjustment it may not be a reasonable indicator of the future.
- When companies are estimating the value of an option with an extended time to maturity, CPAs should recommend they use a longer measurement period to produce more consistent valuation results.

XBRL can save time and money and facilitate information analysis.

XBRL: A Multitalented Tool

BY COLLEEN SAYTHER CUNNINGHAM

CPAs have a rare opportunity to help the business world take a giant leap forward. The extensible business reporting language (XBRL) can vastly improve the timeliness, accuracy and flexibility of data in financial statements and other business reports. Many experts think it will boost today's commerce just as double-entry bookkeeping led to clearer financial statements that attracted investors and stimulated the Industrial Revolution. To help their clients and employers reap the benefits, CPAs need to understand how XBRL can upgrade a variety of business functions, including the representative sample this article briefly describes.

HERE'S HOW

Put XBRL to work in

- ***Fair value accounting.*** Tagging assumption disclosures in XBRL formats would make management's choices more transparent to users and easier to compare with those of other companies—and take away some observers' worries about the reliability of corporate managers' fair value determinations.
- ***Financial statement preparation.*** XBRL makes it easier to create and document financial information and reduce manual intervention. It can help CPAs integrate disparate systems and apply and monitor internal controls, reducing the burdensome costs related to the Sarbanes-Oxley Act of 2002.
- ***Mergers and acquisitions.*** Using XBRL as a universal standard will allow companies to integrate and improve information sharing with regulators, investors and other external entities—and dig out of the morass of useless data that often accompanies corporate consolidations—without moving to uniform hardware or operating systems.
- ***Compliance.*** New SEC rule amendments enable public companies to voluntarily submit XBRL-tagged information as exhibits to some required filings. Participating companies still must submit these filings in traditional electronic format, but the voluntary program will show how XBRL can help improve report quality and usefulness to investors and other end users.
- ***Standard setting.*** XBRL complements the objective of a single set of high-quality, understandable and enforce-

XBRL: A Structure for Business Data

This article continues the *JofA*'s coverage of how XBRL can help CPAs, their clients and employers, regulators, investors and other end users issue, obtain, analyze or translate into other formats—on any computer system—complete and accurate business information.

able global accounting standards and makes it easier to accurately compare financial statements across borders. XBRL also could be a defining factor in the principles vs. rules debate, as seeing all the information in the same format simplifies validation of management's judgments and adjusts company-issued information to suit individual analytical purposes.

■ ***Investment and credit analysis.*** XBRL reduces research costs and makes it easier to create financial models and compare companies' performance and solvency. While virtually all company information is publicly available, few but professional analysts can locate and understand much of it. Tagging data in XBRL improves transparency without additional disclosures and makes more information available to everyone. Making information more accessible also benefits the capital markets, which depend on timely and reliable business data to allocate investments, and helps public companies meet accelerated filing deadlines.

BOTTOM LINE

XBRL benefits all members of the business information supply chain. It's time for companies, government agencies and firms to fundamentally improve business reporting by adopting XBRL. ■

COLLEEN SAYTHER CUNNINGHAM, CPA, is president and CEO of Financial Executives International. Her e-mail address is ccunningham@fei.org.

RESOURCES

XBRL International Inc. Resources

The group's Web site (**www.xbrl.org**) provides

■ An overview of XBRL's functions and capabilities (**www.xbrl.org/whatisxbrl**).

■ Questions frequently asked about XBRL (**www.xbrl.org/faq.aspx**).

■ A technical information center (**www.xbrl.org/technicalinformation**).

■ Details on how to create an XBRL-compliant financial statement (**www.xbrl.org/specifications**).

■ Description of XBRL-enabled applications (**www.xbrl.org/tools**).

■ Descriptions of the benefits as well as the issues involved in adopting XBRL, with sections focusing on special interest groups (**www.xbrl.org/xbrlandbusiness**).

AICPA Resources

■ The AICPA Web site provides extensive XBRL-related information and resources at **www.aicpa.org/innovation/baas/xbrl/homepage.asp**.

■ *XBRL Essentials* (# 093017JA), containing a tutorial and practical information, such as tips on using XBRL to meet business needs, is available at **www.cpa2biz.com** or from the AICPA at 888-777-7077.

■ "XBRL—Real Solutions, Real Time," a free Web-based video (**www.aicpa.org/video/xbrl**).

JofA articles on XBRL:

■ "XBRL Revisited" (Feb.05, page 64 or **www.aicpa.org/pubs/jofa/feb2005/hannon.htm**)

■ "Tap Into XBRL's Power the Easy Way" (May04, page 32 or **www.aicpa.org/pubs/jofa/may2004/naumann.htm**)

■ "A Napster for Financial Data?" (Jan.03, page 66 or **www.aicpa.org/pubs/jofa/jan2003/spec_zar.htm**

■ "Finally, Business Talks the Same Language" (Aug.00, page 24 or **www.aicpa.org/pubs/jofa/aug2000/zarowin.htm**).

Other Resources

■ The World Wide Web Consortium's site provides information about the extensible markup language (XML), of which XBRL is a subset (**www.w3.org/xml**).

■ The 11th XBRL International Conference will be held in Boston, April 25–29, 2005 (**www.xbrl.org/upcomingevents**).

CPAs often overlook the deductibility of investment theft losses.

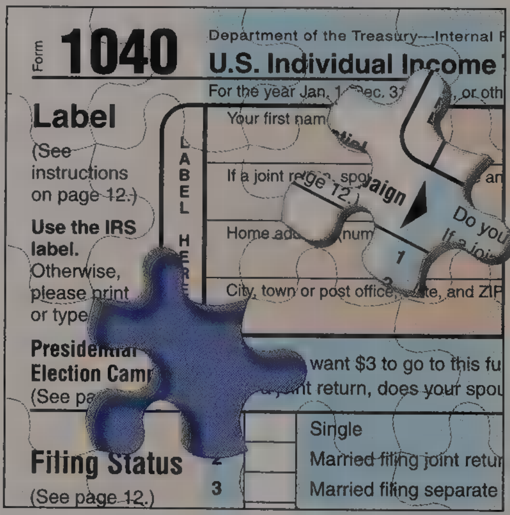
Maximize Tax Benefits Under IRC Section 165

BY BART H. SIEGEL

Investment theft losses that result from nonbusiness, for-profit transactions may qualify for advantageous tax treatment. When a client is the victim of fraud or embezzlement, for example, CPAs can reduce the client's ordinary income, recoup any previously paid taxes and minimize future tax obligations by using IRC section 165(c)(2).

Be aware that CPAs who prepare and defend an investment loss deduction under IRC section 165(c)(2) must meet numerous technical requirements and make certain determinations based on examining the circumstances. Section 165(c)(2) deductions also frequently prompt IRS oversight, and in many instances, the standard tax preparation software does not adequately address this deduction, since it's generally geared to the more familiar section 1211 capital loss treatment. But while section 1211 is an appropriate treatment, using it may result in clients' paying more taxes than are required.

If a client suffers an investment loss as a result of a fraudulent investment or unethical sales practice, probably the most prudent action a CPA can take, even though there is no requirement to do so, is to suggest the client first discuss it with his or her lawyer. Taxpayers are required to take reasonable action to recover a loss and not doing so disqualifies it for section 165(c)(2) treatment. If the lawyer feels there was malfeasance and it is not practical to pursue recovery due to a lack of recoverable assets, the cost of litigation or other reasons, the loss probably is deductible in the current period. Losses from embezzlement, blackmail, kidnapping for ransom, burglary, larceny, extortion and threats also may qualify for section 165 treatment.



KELLEY GRAPHICS

THEFT LOSS VS. CAPITAL LOSS

Section 165(c)(2) theft loss deductions can be more advantageous than capital loss ones for the following reasons:

- As ordinary deductions, they're not subject to limitations imposed by IRC section 1211.
- They're not miscellaneous itemized deductions subject to the 2% floor imposed under section 67(a).
- They're excluded from the phaseout of itemized deductions required by section 68(b).
- Theft losses that exceed a taxpayer's gross income give rise to net operating losses that can be carried back three years or forward for 20 years.
- They can be used to reduce a taxpayer's tax liability to zero without resulting in any liability for alternative minimum tax (AMT).

DETERMINE THEFT LOSS

In *Edwards* v. *Bromberg*, 232 F2d 107 (5th Cir. 1956), the court defined theft as a word of general and broad connotation, covering any criminal appropriation of another's property by swindling, false pretenses or any other form of guile. The court also stated that whether a loss from theft occurred depended on the law of the jurisdiction where it was sustained and the exact nature of the crime. If a transaction did not amount to theft in the state

where the loss was sustained, then section 165(c)(2) is not applicable.

RECOGNIZE FRAUD

For section 165(c)(2) to be applicable, there must be *scienter*, that is, requisite knowledge of the wrongness or illegality of an act. In *Ottmann* v. *Hanger Orthopedic Group*, the Fourth Circuit Court of Appeals determined that *scienter* could be established by pleading not only intentional misconduct, but also severe recklessness. The court further found a plaintiff must meet the "strong inference" requirement of the Private Securities Litigation Reform Act of 1995. Congress did not specify what would or would not show a strong inference of *scienter*, so a case-specific analysis is appropriate to determine it.

In general, the taxpayer needs to have purchased the investment from the person, or an agent of the seller, or entity that made the misrepresentation or committed the malfeasance.

In a standard open-market transaction where a loss results from an illegal act by management, the seller must have been aware of the fraudulent nature of the investment for there to be criminal intent. The transaction may qualify for this treatment if a broker makes reckless statements or circulates half-truths, false opinions or predictions. If a broker recommends the purchase, sale or exchange of any security, he or she generally is required to have reasonable grounds for believing that recommendation is appropriate for that client.

If money was invested for a specified use but used for another or unauthorized use, that loss also may qualify for section 165(c)(2) tax treatment.

TAX BASIS OF INVESTMENT

The theft loss deduction is limited to the tax basis of the investment. This generally is the amount of investment in a property minus previous write-offs, depreciation, amortization or depletion, plus any commissions or transaction costs. In certain cases it is the loss in value of the account that qualifies for the section 165 deduction.

According to several authorities, a taxpayer does not have any tax basis in qualified retirement plan assets such as IRAs or 401(k)s because the Employee Retirement Income Security Act of 1974 established a taxpayer has zero basis in a traditional IRA because no taxes were paid on either the contributions or earnings.

YEAR OF DISCOVERY

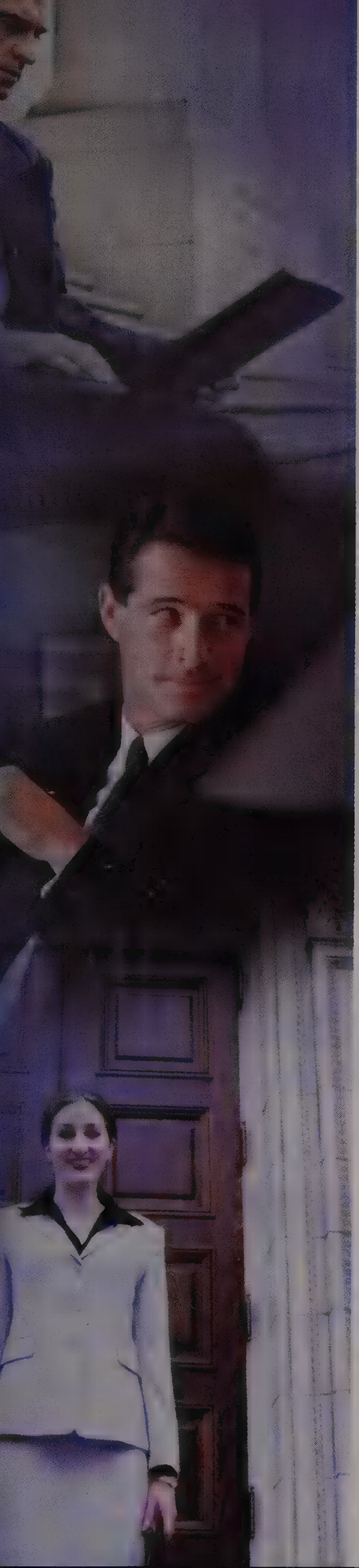
A theft loss is deductible in the year it is discovered by the taxpayer. This may result in an extension of the statute of limitations for a taxpayer who discovers a loss several years after the actual theft. This exception prevents the statute of limitations from voiding the taxpayer's ability to take this deduction. Section 165(a) requires that a loss must be evidenced by closed and completed transactions, fixed by identifiable events and, with certain exceptions, actually sustained during the taxable year.

If, in the year of discovery, there exists a claim for reimbursement with a reasonable prospect of recovery, that portion of the loss is not deductible under section 165(c)(2). The regulations further provide that "whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances." Therefore, the taxpayer must wait for the year in which it can be ascertained with reasonable certainty whether such reimbursement will be received.

If the client claimed a loss under section 165(c)(2) and the reimbursement exceeded what was estimated, the portion of the reimbursement that was previously deducted using section 165 treatment would be treated as ordinary income for tax purposes.

There often are significant benefits to using section 165(c)(2) vs. section 1211 treatment for investment theft losses related to nonbusiness, for-profit transactions. Although it can be burdensome, section 165(c)(2) treatment is worth consideration. ■

BART H. SIEGEL, CPA/PFS, is an independent investment and tax consultant retained by JK Harris 165 Services LLC, which specializes in substantiating investment theft losses. His e-mail address is bsiegel@tampabay.rr.com.



Tax Matters

TAX CASES

Buy-Sell Agreements

There are numerous legitimate business reasons to establish a buy-sell agreement for a closely-held family business. Many of these agreements set the value for estate tax purposes when one of the shareholders dies. If the IRS rejects the price set to represent the value of the stock, a significant estate tax liability may result. Recently, the Tenth Circuit Court of Appeals examined the validity of a buy-sell agreement and rejected its price as the stock's value, siding with the Tax Court and the IRS.

H.A. True Jr. created numerous oil and gas and related companies, all of them family-owned. Each company had a mandatory buy-sell agreement that obligated shareholders to sell the stock back to the other shareholders when they left the corporation's employment or wanted to dispose of the shares. The price was set at the book value of the shares. When True died on June 4, 1994, his stock was sold to the other shareholders (family members) at the stated book value. The IRS revalued the stock for estate tax purposes. The estate objected and filed with the Tax Court. The court sided with the IRS, and the estate appealed.

Result. For the IRS. In reaching its decision the Tenth Circuit reviewed the four requirements for a valid buy-sell agreement:

- The price must be determined by the agreement.
- The terms of the agreement must be binding throughout life and death.
- The agreement must be legally binding and enforceable.
- The agreement must be entered into for bona fide business reasons—not as a testamentary substitute designed to pass assets to beneficiaries at less than full and adequate consideration.

The agreement met the first three requirements. The question was whether it met the fourth.

In evaluating the fourth requirement, it is important to note that it contains two separate tests. First, the buy-sell agreement has to have been entered into for a legitimate business purpose. Second, the agreement cannot be a testamentary device. The estate convinced the Tax Court there was a legitimate business purpose for the agreement, but it did not overcome the presumption of a testamentary device.

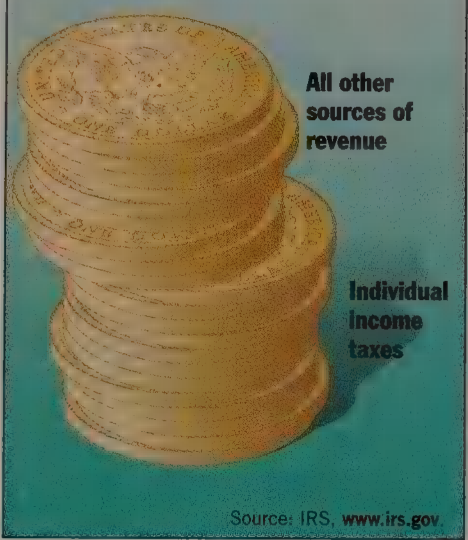
Prior cases evaluating testamentary devices have considered the following factors: the health or age of decedent on entering into the agreement; the lack of regular enforcement of the agreement; the exclusion of significant assets from the agreement; the arbitrary manner in which the price was set; the lack of negotiations among the parties; whether the agreement allowed adjustments or revaluation; whether all parties were bound by the agreement; and other evidence of a testamentary plan. Using these factors the court found too many indications of a testamentary device.

The court found the price was set arbitrarily and was not based on an appraisal or in consultation with professionals. There was no revaluation or adjustment to the price in the buy-sell agreement. No negotiations took place. True had arbitrarily set the price and the terms. The use of book value left out significant assets—in this case, the oil reserves. Finally, there was evidence of a testamentary plan as a result of the deletion of the daughter from his will when she sold her stock.

Losing on the testamentary device issue does not automatically mean the value set was incorrect. It means only

We the People

Individual income taxes account for more than half of total federal tax collections. In 2001, for example, individuals paid $1.2 trillion of the $2.1 trillion the government received.

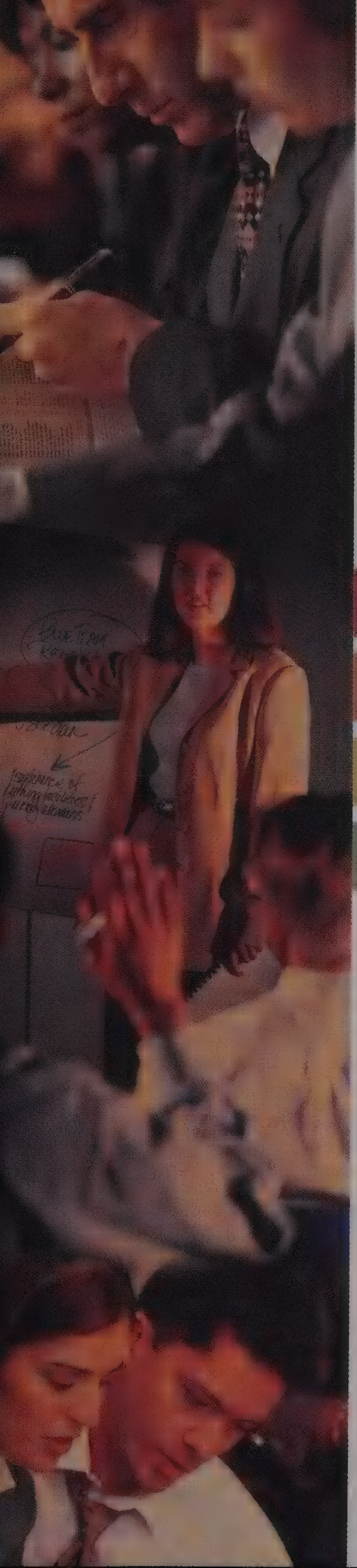


Source: IRS, www.irs.gov.
CHART: KELLEY GRAPHICS

Tax Pumps Up Gas Prices

Federal and state taxes account for 22.5% of what Americans pay for gasoline at the pump. In July 2004 the average tax was 43.7 cents a gallon.

Source: American Petroleum Institute, http://api-ec.api.org/frontpage.cfm, 2004.
GRAPHIC: KELLEY GRAPHICS



that the agreement will not be automatically honored. The taxpayer still can prove the agreement provided for full and adequate consideration if the agreed price equals the stock's fair market value. The estate argued that under *Broderick* v. *Gore* (224 F2d 892 (CA-10)), and in several other cases, a buy-sell agreement that was mandatory for all parties was, by definition, fair market value. However, the appellate court said the cases cited by the estate were based on old law before the issuance of new regulations. Consequently, the cases were no longer an enforceable precedent. Examining the buy-sell agreement based on the evidence of actual value, the court concluded the price was not the value of the stock.

This case provides an excellent review of the qualification to use a buy-sell agreement to set values for gift and estate tax purposes. It would be relevant to other businesses that have developed intangibles through R&D since these would not be recorded on the books. The court, by rejecting precedent, made it more important that these agreements meet all the requirements and not just the one involving enforceability.

■ *Estate of H.A. True, Jr.* v. *Commissioner*, 2004 US LEXIS 24844 (CA-10).

Prepared by Edward J. Schnee, CPA, PhD, *Hugh Culverhouse Professor of Accounting and director, MTA program, Culverhouse School of Accountancy, University of Alabama, Tuscaloosa.*

Is There a Doctor in The Big House?

In the first half of 2003, 76.5% of medical professionals convicted of tax fraud were sentenced to prison and/or house arrest.

Source: IRS, www.irs.gov

GRAPHIC: KELLEY GRAPHICS

Does Bankruptcy Terminate S Corp Status?

A business that elects to be an S corporation continues to be taxed as such until the election is terminated. It can be terminated in any of three ways: (1) The shareholders revoke the election, (2) the corporation no longer satisfies the eligibility requirements or (3) the corporation has too much passive income during the three previous tax years.

Alphonse Mourad was the sole shareholder of V&M Management, an S corporation that owned and operated a 275-unit apartment complex. In 1996 V&M petitioned for reorganization under chapter 11 of the Bankruptcy Code. To administer the reorganization, the bankruptcy court appointed an independent trustee who, in 1997, sold the apartment complex. The sale resulted in a gain of $2.1 million, which was reported on V&M's 1997 form 1120S and Mourad's 1997 schedule K-1. Mourad did not file a tax return for 1997, the IRS issued him a notice of deficiency for that year and he, in turn, petitioned the Tax Court for relief.

Mourad argued the gain should have been reported by V&M, not by him, since V&M's filing for bankruptcy had terminated its status as an S corporation. The Tax Court disagreed (see *Mourad* v. *Commissioner*, 121 TC no. 1). The Tax Court held that a bankruptcy proceeding conducted under chapter 11 did not end S corporation status. Its finding was similar to that in an earlier case, *In re Stadler Associates, Inc*, 186 Bankr. 762, in which a bankruptcy court decided a petition under chapter 7 of the bankruptcy laws had not terminated S corporation status. In *Stadler* the court said that, if it permitted a bankruptcy to end S corporation status, it would be adding a fourth way of S corporation termination not specified in the tax code.

Mourad also argued it was unfair to tax him on the income of the property during the bankruptcy proceeding since he had received no benefit from it during that time. The court disagreed with this as well, saying Mourad had single taxation before the bankruptcy and also had benefited later, since the proceeds from the sale of the property reduced the liabilities of V&M for which he was personally responsible. Mourad appealed the decision to the First Circuit Court of Appeals.

Result. For the IRS. The taxpayer reiterated that V&M's S corporation status ended when it entered bankruptcy proceedings but now used the argument that V&M no longer met the eligibility requirements under the Internal Revenue Code. He said when the trustee took control of V&M the corporate creditors were, in essence, the new owners. Since these new owners were not individuals, V&M no longer was an eligible corporation and its S corporation status was terminated. He also argued that another class of stock had been created because the "new owners" had rights and preferences different from his; therefore V&M was no longer an eligible corporation.

The appellate court rejected these arguments, saying the trustee was more like the management of V&M and that neither the trustee nor the creditors took the place of the taxpayer as the sole shareholder. It said the law states any income in a bankruptcy case should be "taxed only as though such case had not been commenced." The court agreed with the Tax Court that none of the three ways the tax code laid out for terminating an S corporation applied in this case. The court also could find no shareholders with different rights from the taxpayer's. This case emphasizes that a bankruptcy proceeding under Chapter 11 does not affect the S corporation status of an entity.

■ *Alphonse Mourad* v. *Commissioner*, 387 F3d 27.

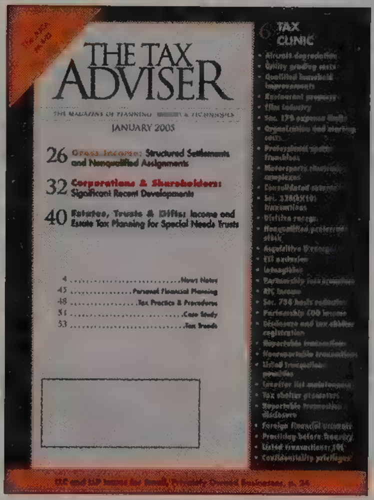
Prepared by Charles J. Reichert, CPA, *professor of accounting, University of Wisconsin, Superior.* ■

Failure to execute a disclaimer can be a costly mistake.

From The Tax Adviser:

The Importance of a Valid Disclaimer

While estate planning normally occurs during life, it also can occur after a taxpayer's death. In letter ruling (technical advice memorandum) 200437032, the IRS ruled that a bequest to a member of a religious order who had taken a vow of poverty did not qualify for the estate tax charitable deduction under IRC section 2055. CPAs should take note of this ruling—it illustrates how the failure to execute a disclaimer can be an expensive mistake.



FACTS

The decedent's sister, a member of a Roman Catholic religious order, had taken a perpetual vow of poverty that effectively turned over all of the assets she might thereafter own to the order.

The decedent's will left his entire estate to his sister. Had she predeceased him, the order would have received the bequest. Instead, more than nine months after the decedent's death, his sister transferred all of the assets to the order but did not execute a disclaimer. Had she done so, the assets would have passed directly to the order—as if the sister had never been bequeathed them—and qualified for an estate tax charitable deduction.

ARGUMENTS

The estate raised a number of arguments, as follows—all of which the IRS rejected:

- The vow of poverty qualified as a disclaimer under IRC section 2518(a). The IRS said that, because the vow was not made in accordance with state law, it did not qualify as a disclaimer.
- The vow and subsequent transfer of assets to the order constituted a valid disclaimer under section 2518(c)(3), which requires a written transfer and passing of the assets to the party that would have received them had a valid disclaimer been executed. The service again disagreed, citing case law, legislative history and its own rulings.
- The vow terminated the sister's interest in the legacy, under section 2055(a)'s "flush" language (that is, complete termination of a power to consume property before such power has been exercised shall be deemed a disclaimer). The IRS merely stated that the flush language did not apply in this case.

Thus, the estate was denied a charitable deduction for the assets passing to the order.

A BETTER RESULT

To ensure the transfer to the order would qualify for an estate tax deduction, the will should have provided a direct legacy. For example, if the decedent had wanted to provide for his sister if she left the order, the will could have stated: "In the event that my sister is no longer subject to a vow of poverty at my death, I give her my residuary estate. But if she is subject to such a vow, then I give my residuary estate to the order."

CONCLUSION

Clearly, the sister should have been advised to execute a disclaimer. Because she did not, the order had to bear the entire estate tax on the bequest.

For more information, see the Tax Clinic, edited by Jerry Lerman, in the April 2005 issue of *The Tax Adviser.*

—*Lesli S. Laffie, editor*
The Tax Adviser

Notice to readers: Members of the AICPA tax section may subscribe to *The Tax Adviser* at a reduced price. Contact Judy Smith at 202-434-9270 for a subscription to the magazine or to become a member of the tax section.

Technology Q&A

Count the empty cells in Excel...Add, remove or modify a word in spell check...Calculate future and past dates...Speed up Internet surfing...Update e-mail contacts...Get Windows XP to shut down faster...Print the path and file name in Excel...Let Google search while you sleep...Print booklets in a snap...Shortcuts

BY STANLEY ZAROWIN

Key to Instructions

To help readers follow the instructions in this article, we use two different typefaces:

- **Boldface type** is used to identify the names of icons, agendas and URLs.
- Sans serif type shows commands and instructions users should type into the computer and the names of files.

COUNT THE EMPTY CELLS IN EXCEL

Q. I'm puzzled. I use the COUNT function to determine how many cells in a worksheet contain numbers and the COUNTA function to tally the empty cells. But when I compare the two results to double-check my answer, it never comes out right. It's like there are phantom cells. Is this an Excel bug?

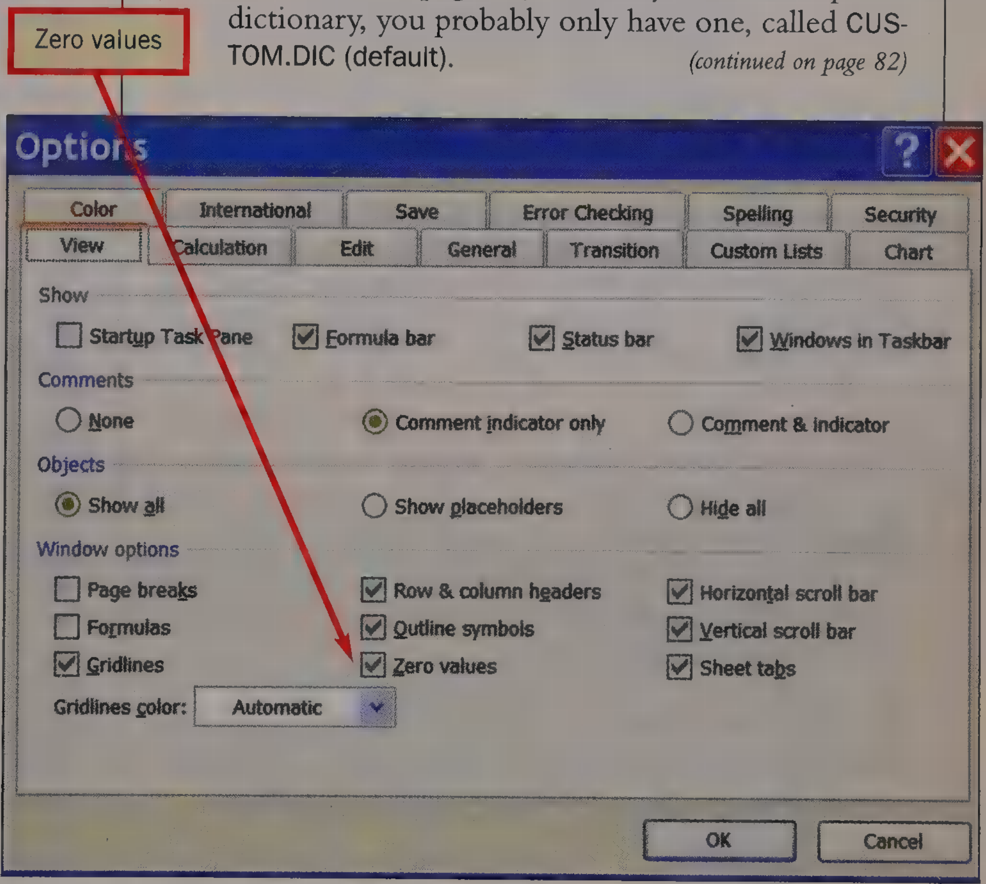
A. I'm afraid you've missed some subtleties of Excel's COUNT function. You're obviously unaware that Excel is counting cells with zero values as empty. You can change the program's default, though, so it doesn't do that. Here's how: Go to **Tools**, **Options**, **View** and uncheck **Zero values** on the bottom of the **Options** screen (see screenshot at right).

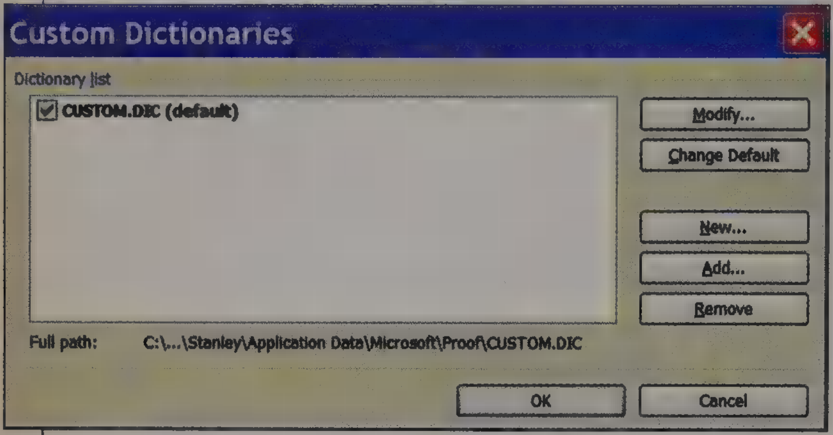
ADD, REMOVE OR MODIFY A WORD IN SPELL CHECK

Q. Window's spell check is one of my favorite features—except for one thing: Every now and then I OK a word (usually a name) and later learn I misspelled it. But once it's in the dictionary, I can't figure out how to change it. Any suggestions?

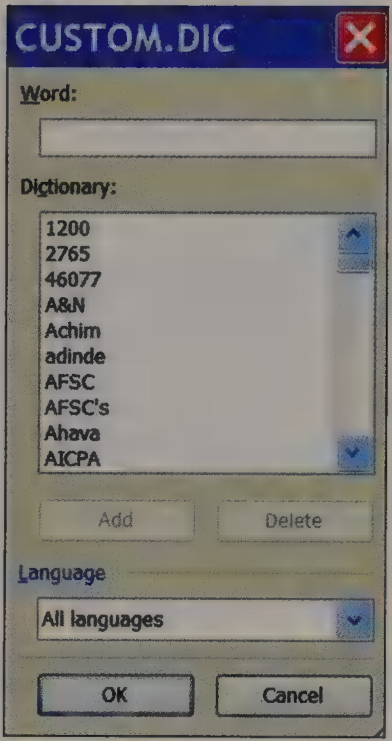
A. You can edit the dictionary. It used to be a real chore in pre-XP versions of Windows Office, but now it's a breeze. Note, however, that the spell-check dictionary is used by all Windows applications—Word, Excel, Access, PowerPoint and OneNote—but you can edit only in Word. So to change a spelling in its memory, no matter what Office application you're working in, you must first open Word. Then go to **Tools**, **Options**, **Spelling & Grammar** and click on **Custom Dictionaries** (see screenshot on page 82). Unless you added a special dictionary, you probably only have one, called CUSTOM.DIC (default).

(continued on page 82)





To add, remove or modify a word, click on **Modify**, which brings up the **CUSTOM.DIC** screen below. Don't click on **New** or **Add**; those buttons are for adding a dictionary, not a word. You can find many specialty dictionaries on subjects from accounting to zoology by searching the Internet.



To fix a spelling, first delete the incorrect version by scrolling to the word you want to change and deleting it. Then type the correct version in the space under the **Word** heading and click on **Add** and **OK**.

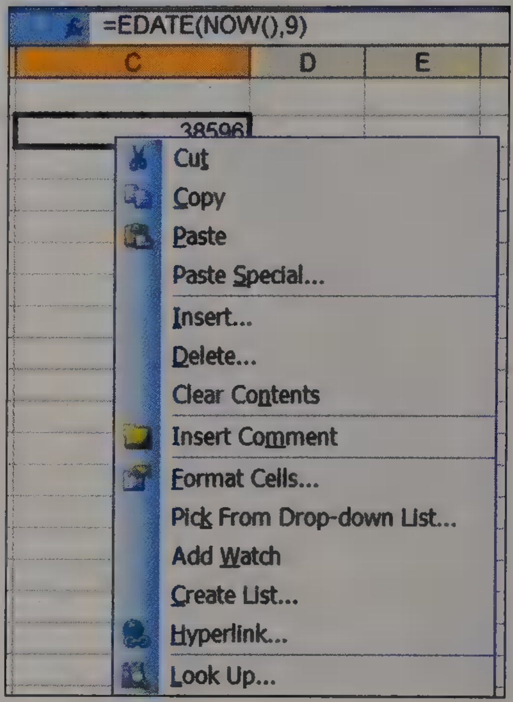
CALCULATE FUTURE AND PAST DATES

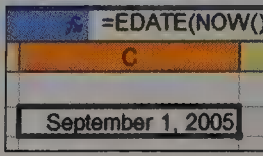
Q. One of my monthly tasks is to calculate contract expiration dates. If I know a contract will expire in nine months from a given date, for example, can Excel figure out the actual expiration date?

A. The EDATE function, when linked with the NOW function, can do that. If you want to know a date nine months from today, use the formula: =EDATE(NOW(),9).

If you want the date nine months ago, use a negative number in the formula, such as: =EDATE(NOW(),-9).

Caveat: If your answer is a five-digit number instead of a date, it means you failed to format the cell correctly. To prepare a cell to exhibit its answer as a date, right-click on the cell to bring up the format screen (see screenshot below) and select the date format you want. The result will be the screenshot on the right.





In the unlikely event EDATE fails to work, you probably haven't enabled **Analysis ToolPak**, which is usually in Excel but by default isn't enabled. To turn it on, click on **Tools**, **Add-Ins**. One of the options will be **Analysis ToolPak**. Click on it and then on **OK**.

If **Analysis ToolPak** is not among the options, it probably wasn't installed when Excel or Office was first loaded on your computer. In that case, you'll have to reinstall Excel from the original disks. When you do, be sure to install the Excel add-ins when the option is presented.

SPEED UP INTERNET SURFING

Q. Because of my location I'm stuck with a dial-up Internet connection and, as you can imagine, it doesn't surf the Net, it crawls. How can I boost the speed?

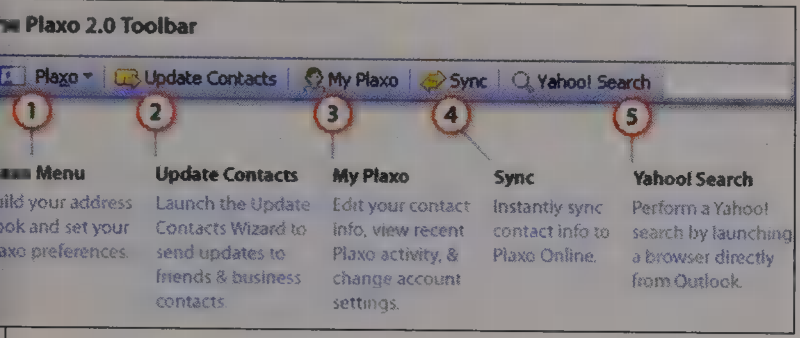
A. One thing you can do is program your browser to omit graphics, which demand loads of downloading time. That will improve the speed, but, of course, you'll miss out on the pictures. To omit graphics, if your browser is Internet Explorer, click on **Tools**, **Internet Options** and the **Advanced** tab. In the **Internet Options** dialog box scroll in the **Settings** window to the **Multimedia** category and remove the check at **Show Pictures**. Then click on **Apply** and **OK**.

Another alternative is to add an accelerator to your modem software. That subject was covered in this column in the April 2004 *JofA*, page 91 (**www.aicpa.org/pubs/jofa/apr2004/tech_qa.htm**).

UPDATE E-MAIL CONTACTS

Q. My customers and vendors seem to move around a lot, and I have a devil of a time keeping my Outlook contacts up to date. Any ideas?

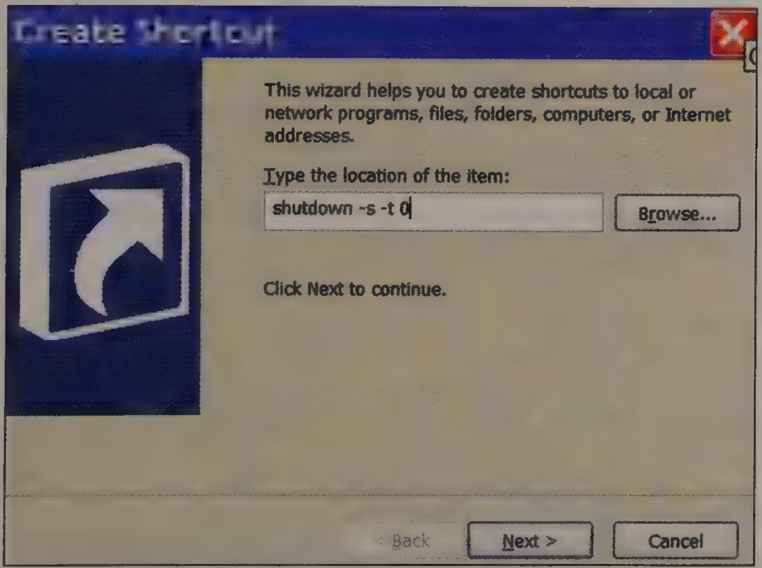
A. There's a free program, Plaxo, you can automatically e-mail to everyone in your address book, inviting them to update all their contact information. Plaxo also will send you a toolbar that makes it easy to initiate such an invitation to all your current contacts (see screenshot). To find out more, go to **www.plaxo.com**.



GET WINDOWS XP TO SHUT DOWN FASTER

Q. I understand why Windows XP takes ages to fire up—after all, it has to load so much start-up software. But why does it also take so long to close down?

A. It's because Windows has to turn off each application you have left open—saving critical data along the way. Then it runs a quick system check before it goes to sleep. But there is a way to speed up the process by a few seconds. In a blank area of your desktop, right-click and then select **New**, **Shortcut** and in the **Create Shortcut** screen type shutdown -s -t 0 (see screenshot below). Be sure there's a space before each hyphen and the last character is a zero, not the letter O. Then click on **Next** and in the **Type a Name for This Shortcut** box, enter a title and click on **Finish**.

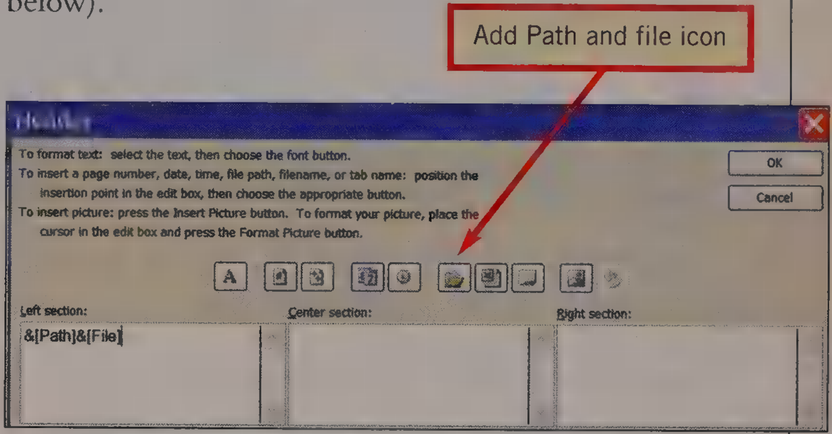


Advisory: Be sure to save and close all applications before initiating any shutdown to make the process faster.

PRINT THE PATH AND FILE NAME IN EXCEL

Q. Microsoft's instructions may be intuitive to you, dear editor, but not to many others. You stated in your article "The Best of Technology Q&A" (Dec.04, page 83): "Here are the steps to create a header/footer....The rest is intuitive—so just follow the screen instructions." But when I tried to follow the screen instructions for adding the path and file name to an Excel workbook, I was confronted with a bunch of unidentified icons (see screenshot below). Please, which one adds the path and file name?

A. My apologies. So you don't have to play hide-and-seek, it's the icon with the yellow folder that has the corner of a piece of paper peeking out (see screenshot below).

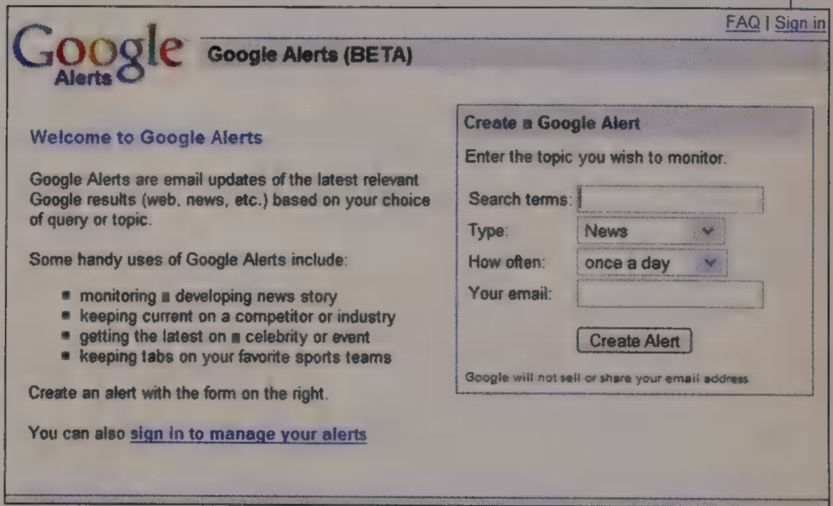


LET GOOGLE SEARCH WHILE YOU SLEEP

Q. To keep current, I regularly do Internet searches on my company's products, customers and competitors, but that takes a lot of time. Is there some way to program the computer to do such searches on a regular basis?

A. Google, the Internet search engine, recently introduced a beta product called Google Alerts (see screenshot below).

(continued on page 84)



It's a free service that automatically does what you're now doing manually.

Just provide Alerts with the key words for your queries and tell it how often you want to be alerted (once a week, once a day or as it happens) and whether you want to search the news, the Web or both. Alerts will send you an e-mail with every new thing it uncovers. To engage the service, go to **www.googlealert.com**.

When I first discovered it, I signed up and entered my last name to test it. Within days it alerted me that a long-lost cousin had just won an award as a sports coach and confirmed that I write for the *Journal of Accountancy*.

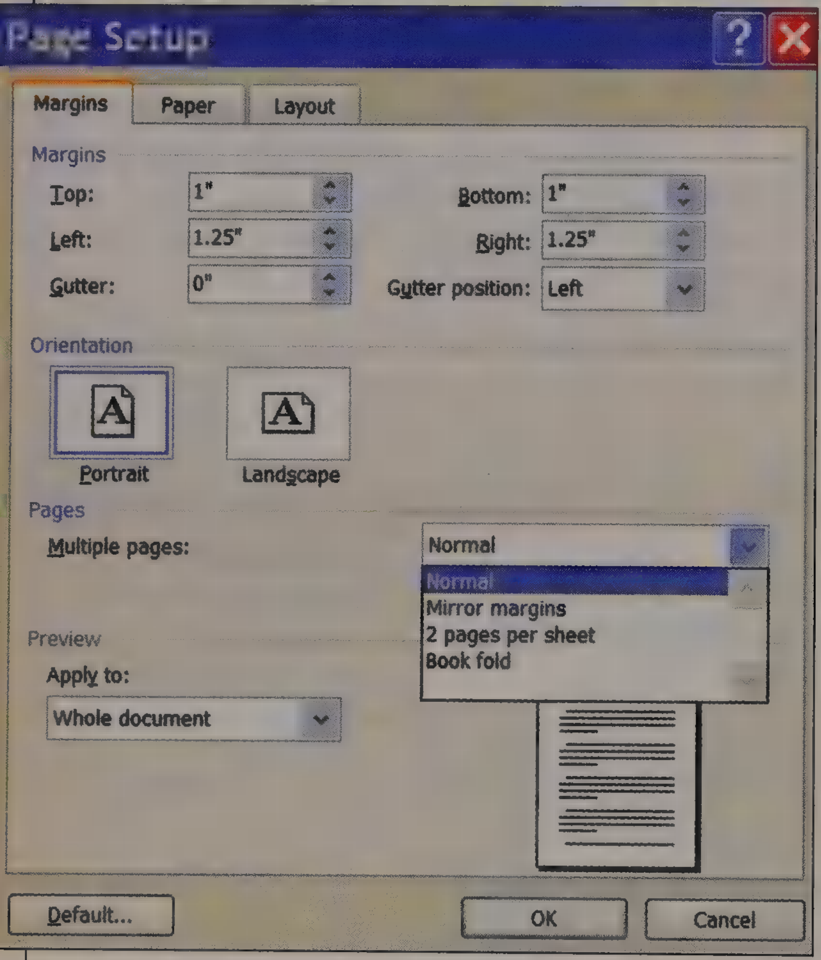
PRINT BOOKLETS IN A SNAP

Q. My firm decided to publish a brochure describing our accounting and consulting specialties for new and prospective clients. To save money I volunteered to prepare it in Word. But when I tried to format it, I realized I might have spoken too soon. Do you have any advice?

A. If you had asked me that question before Word 2002 was introduced, I would have suggested you seek out a professional printer. But now Word has features that make it simple.

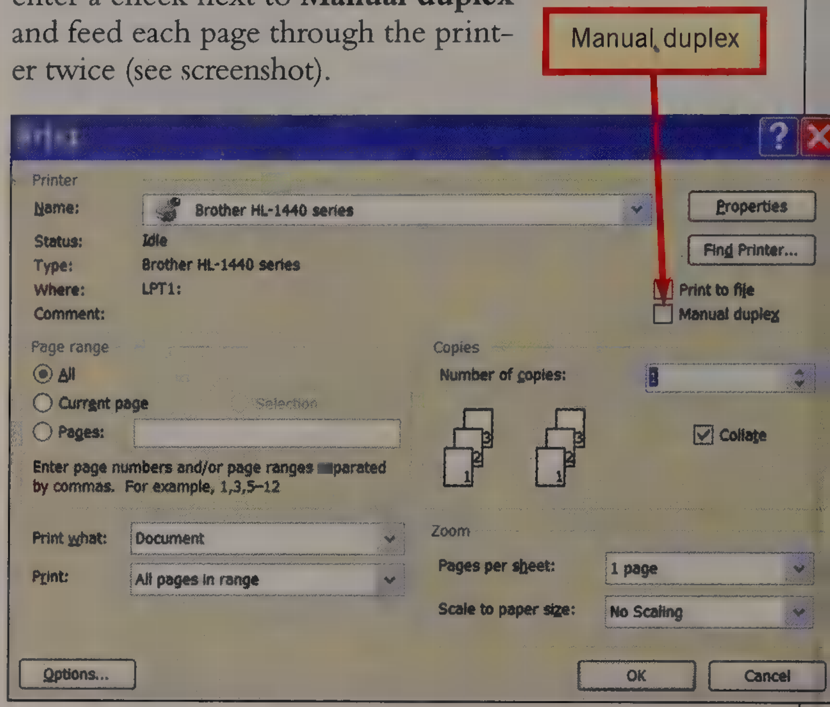
In the **File** menu click on **Page Setup** and the **Margins** tab. Go to the **Multiple pages** drop-down list and click on **Book fold** (see screenshot).

You'll have to adjust the margins to fit your needs.



When finished, click on **OK** and the document automatically will be formatted.

When you're ready to print, click on **File**, **Print** and opt to print two-sided. If you don't have a duplex printer, enter a check next to **Manual duplex** and feed each page through the printer twice (see screenshot).



SHORTCUTS

- **Windows Explorer:** Quick way to access files without quitting your browser: Type C:\ in the browser address bar and press Enter.
- **Word:** A quick way to remove all formatting: Ctrl+Shift+Z (resets to Normal default).
- **Word:** To left-align a paragraph: Ctrl+L; to align right: Ctrl+R; to center: Ctrl+E; to justify: Ctrl+J. ■

STANLEY ZAROWIN, a former *JofA* senior editor, is now a contributing editor to the magazine. His e-mail address is zarowin@mindspring.com.

Do you have technology questions for this column? Or, after reading an answer, do you have a better solution? Send them to contributing editor Stanley Zarowin via e-mail at zarowin@mindspring.com or regular mail at the *Journal of Accountancy*, 201 Plaza Three, Harborside Financial Center, Jersey City, NJ 07311-3881.

Because of the volume of mail, we regret we cannot individually answer submitted questions. However, if a reader's question has broad interest, we will answer it in a Technology Q&A column.

On occasion you may find you cannot implement a function I describe in this column. More often than not it's because not all functions work in every operating system or application. I try to test everything in the 2000 and XP editions of Windows and Office. It's virtually impossible to test them in all editions and it's equally difficult to find out which editions are incompatible with a function. I apologize for the inconvenience.

Exposure Drafts Outstanding

(This list was compiled as of March 1, 2005. For exposure drafts issued after that date, consult *The CPA Letter*. *Note:* The policy for updating the list of exposure drafts is that a document should remain on the list until a final document has been issued or the project has been dropped. However, no comments will be received after the comments deadline has expired. The list is not all-inclusive but is intended to present the exposure drafts of particular interest to professional accountants.)

Issue Date	Title or Description	Comment Deadline
FASB		
6/23/04	Fair Value Measurements	9/7/04
6/17/04	Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143	8/1/04
12/15/03	Earnings per Share—an amendment of FASB Statement No. 128	4/13/04
12/15/03	Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3	4/13/04
6/10/03	Qualifying Special-Purpose Entities and Isolation of Transferred Assets—an amendment of FASB Statement No. 140	7/31/03
10/27/00	Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities, an Amendment of FASB Concepts Statement No. 6	3/31/01
10/27/00	Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both	3/31/01
12/14/99	Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value (preliminary views)	5/31/00
2/23/99	Consolidated Financial Statements: Purpose and Policy	5/24/99
AcSEC (AICPA)		
11/29/04	Proposed Statement of Position, Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements	1/7/05
6/19/03	Proposed Statement of Position, Allowance for Credit Losses	9/19/03
12/17/02	Proposed Statement of Position, Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investment in Investment Companies	3/31/03
ASB (AICPA)		
1/12/05	Proposed Statement on Auditing Standards: Audit Documentation	5/15/05
3/18/03	Proposed Statement on Auditing Standards, Communication of Internal Control Related Matters Noted in an Audit	5/30/03
3/18/03	Proposed Statements on Auditing Standards and Statement on Standards for Attestation Engagements Related to Internal Control: Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit; Amendment to Statement on Auditing Standards No. 100, Interim Financial Information; and Reporting on an Entity's Internal Control over Financial Reporting*	5/15/03
4/1/03	Proposed Statement on Auditing Standards, Sarbanes-Oxley Omnibus Statement on Auditing Standards*	5/15/03
12/2/02	Proposed Statements on Auditing Standards: Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards; Audit Evidence; Audit Risk and Materiality in Conducting an Audit; Planning and Supervision; Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement; Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained; and Amendment to Statement on Auditing Standards No. 39, Audit Sampling	4/30/03
OTHER (AICPA)		
9/20/04	XBRL US Financial Reporting Taxonomy Framework	11/19/04
11/15/02	Proposed Tax Standards Interpretation 1-2, "Tax Planning," of Statement on Standards for Tax Services No. 1, *Tax Return Positions*	4/30/03
11/1/01	AICPA/NASBA Uniform Accountancy Act and Uniform Accountancy Act Rules	12/31/01
3/7/01	Statement on Standards for Continuing Professional Education Programs	8/1/01
SEC		
4/15/04	Use of Form S-8 and Form 8-K by Shell Companies; Release No. 34-49566	6/7/04
3/11/04	First-Time Application of International Financial Reporting Standards; Release Nos.: 33-8397; 34-49403; International Series Release No. 1274 (See Correction 3/18/04; Release Nos. 33-8397A; 34-49403A; International Series Release No. 1274A)	4/19/04
6/26/02	Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process; Release Nos. 33-8109; 34-46120; 35-27543; IA-2039; IC-25624	9/3/02

New additions appear in ***bold*** *type. (No new additions this month.)*

*This exposure draft has been submitted to the Public Company Accounting Oversight Board for its consideration as auditing and attestation standards.

EXPOSURE DRAFTS OUTSTANDING

Issue Date	Title or Description	Comment Deadline
5/10/02	Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies (Release Nos. 33-8098; 34-45907)	7/19/02
4/12/02	Form 8-K Disclosure of Certain Management Transactions; Release No. 33-8090	6/24/02
4/12/02	Form 8-K Disclosure of Certain Management Transactions; Release No. 34-45742	6/24/02
2/18/00	SEC Concept Release: International Accounting Standards	5/23/00
1/21/00	Supplementary Financial Information	4/17/00
GASB		
12/10/04	Accounting for Termination Benefits	3/11/05
6/23/04	Communication Methods	9/30/04
IFAC		
11/9/04	International Guidelines on Environmental Management Accounting (EMA)	2/28/05
10/5/04	Proposed Revised Code of Ethics for Professional Accountants	11/30/04
9/23/04	Policy Statement, "Clarifying Professional Requirements in International Standards" and Consultation Paper, "Improving the Clarity and Structure of IAASB Standards and Related Considerations for Practice Statements"	12/31/04
9/23/04	ISA 230 (Revised), "Audit Documentation" and amendments to ISA 330, "The Auditor's Procedures in Response to Assessed Risks" and ISQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial and Other Assurance and Related Services Engagements"	1/31/05
7/14/04	Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services—IAASB Due Process and Working Procedures	10/15/04

Issue Date	Title or Description	Comment Deadline
1/20/04	Revenue from Non-Exchange Transactions (Including Taxes and Transfers)	6/30/04
1/20/04	Accounting for Social Policies of Governments	6/30/04
12/23/03	ISA 600 (Revised), "The Work of Related Auditors and Other Auditors in the Audit of Group Financial Statements" and IAPS, "The Audit of Group Financial Statements"	3/31/04
12/22/03	ISA700 (Revised), "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" Amendment to ISA 210, "Terms of Audit Engagements" Conforming Amendments	3/31/04
11/11/03	Revision to Code of Ethics for Professional Accountants	2/15/04
7/18/03	Proposed Revised Code of Ethics for Professional Accountants	11/30/03
6/24/03	Proposed International Standard on Auditing: "Review of Interim Financial Information Performed by the Auditor of the Entity"	9/30/03
FASAB		
4/26/04	Inter-Entity Cost Implementation: Amending SFFAS 4, "Managerial Cost Accounting Standards and Concepts"	7/31/04
8/20/03	Heritage Assets and Stewardship Land: Reclassification from Required Supplementary Stewardship Information	11/10/03
4/21/03	Accounting for Fiduciary Activities	7/31/03
GAO		
10/6/04	Guidance on GAGAS Requirements for Continuing Professional Education	11/30/04

PCAOB

At the present time PCAOB exposure drafts have very short comment periods. A list of outstanding PCAOB exposure drafts is available online at **www.pcaobus.org**.

INFORMATION

The initials stand for the following organizations. Exposure drafts are available online at the Web addresses below or copies may be obtained at the address in parentheses (unless otherwise indicated).

FASB— Financial Accounting Standards Board (Order Department, Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); also available online at **www.fasb.org**

GASB— Governmental Accounting Standards Board (Order Department, Governmental Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); also available online at **www.gasb.org**

AICPA— American Institute of CPAs (American Institute of Certified Public Accountants, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881). AICPA publishes exposure drafts exclusively on the Web site at **www.aicpa.org**. Print copies are not available.

IASB— International Accounting Standards Board (International Accounting Standards Board, 30 Cannon Street, London EC4M 6XH, United Kingdom), also available online at **www.iasb.org.uk**

IFAC— International Federation of Accountants (International Federation of Accountants, 545 Fifth Avenue, 14th Floor, New York, NY 10017); also available online at **www.ifac.org**

SEC— Securities and Exchange Commission (Securities and Exchange Commission, 450 5th Street, N.W., Washington, DC 20549); also available online at **www.sec.gov**

FASAB— Federal Accounting Standards Advisory Board (Federal Accounting Standards Advisory Board, 441 G Street, N.W., Suite 6814, Washington, DC 20548); also available online at **www.fasab.gov**

GAO— U.S. Government Accountability Office (Government Auditing Standards Comments, Marcia B. Buchanan, U.S. General Accounting Office, Room 5089, 441 G Street, N.W., Washington, DC 20548); **www.gao.gov**

PCAOB— Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, DC 20006-2803; info@pcaobus.org

AICPA TECHNICAL HOTLINE

The Technical Information Service answers inquiries about specific audit or accounting problems. Call toll-free **888-777-7077** or e-mail query to **aahotline@aicpa.org. This service is free to AICPA members.**

Official Releases

FASB No. 123 (revised 2004)...Ethics Interpretation

Space considerations prevent publishing here the appendices to FASB Statement no. 123 (revised 2004). Since the appendices often are important to understanding FASB statements, readers are advised to obtain complete copies. For additional copies of FASB statements and/or information on applicable prices and discount rates, contact the FASB order department, 401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856–5116. Telephone: 800–748–0659.

Statement of Financial Accounting Standards No. 123 (revised 2004)—Share-Based Payment

SUMMARY

This Statement is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation.* This Statement supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance.

Scope of This Statement

This Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. This Statement does not change the accounting guidance for share-based payment transactions with parties other than employees provided in Statement 123 as originally issued and EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." This Statement does not address the accounting for employee share ownership plans, which are subject to AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans.*

Reasons for Issuing This Statement

The principal reasons for issuing this Statement are:

a. Addressing concerns of users and others. Users of financial statements, including institutional and individual investors, as well as many other parties expressed to the FASB their concerns that using Opinion 25's intrinsic value method results in financial statements that do not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for equity instruments. Financial statements that do not faithfully represent those economic transactions can distort the issuer's reported financial condition and results of operations, which can lead to the inappropriate allocation of resources in the capital markets. Part of the FASB's mission is to improve standards of financial accounting for the benefit of users of financial information. This Statement addresses users' and other parties' concerns by requiring an entity to recognize the cost of employee services received in share-based payment transactions, thereby reflecting the economic consequences of those transactions in the financial statements.

b. Improving the comparability of reported financial information by eliminating alternative accounting methods. Over the last few years, approximately 750 public companies have voluntarily adopted or announced their intention to adopt Statement 123's fair-value-based method of accounting for share-based payment transactions with employees. Other companies continue to use Opinion 25's intrinsic value method. The Board believes that similar economic transactions should be accounted for similarly (that is, share-based compensation transactions with employees should be accounted for using one method). Consistent with the conclusion in the original Statement 123, the Board believes that those transactions should be accounted for using a fair-value-based method. By requiring the fair-value-based method for all public entities, this Statement eliminates an alternative accounting method; consequently, similar economic transactions will be accounted for similarly.

c. Simplifying U.S. GAAP. The Board believes that U.S. generally accepted accounting principles (GAAP) should be simplified whenever possible. Requiring that all entities follow the same accounting standard and eliminating Opinion 25's intrinsic value method and its related detailed and form-driven implementation guidance simplifies the authoritative literature.

d. Converging with international accounting standards. This Statement will result in greater international comparability in the accounting for share-based payment transactions. In February 2004, the International Accounting Standards Board (IASB), whose standards are followed by entities in many countries, issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment.* IFRS 2 requires that all entities recognize an expense for all employee services received in share-based payment transactions, using a fair-value-based method that is similar in most respects to the fair-value-based method established in Statement 123 and the improvements made to it by this Statement. Converging to a common set of high-quality financial accounting standards for share-based payment transactions with employees improves the comparability of financial information around the world and makes the accounting requirements for entities that report financial statements under both U.S. GAAP and international accounting standards less burdensome.

Key Provisions of This Statement

This Statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award—the requisite service period (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service. Employee share purchase plans will not result in recognition of compensation cost if certain conditions are met; those conditions are much the same as the related conditions in Statement 123.

A nonpublic entity, likewise, will measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of those instruments, except in certain circumstances. Specifically, if it is not possible to reasonably estimate the fair value of equity share options and similar instruments because it is not practicable to estimate the expected volatility of the entity's share price, a nonpublic entity is required to measure its awards of equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of its share price.

A public entity will initially measure the cost of employee services received in exchange for an award of liability instruments based on its current fair value; the fair value of that award will be remeasured subsequently at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as compensation cost over that period. A nonpublic entity may elect to

measure its liability awards at their intrinsic value through the date of settlement.

The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments (unless observable market prices for the same or similar instruments are available). If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

Excess tax benefits, as defined by this Statement, will be recognized as an addition to paid-in capital. Cash retained as a result of those excess tax benefits will be presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost will be recognized as income tax expense unless there are excess tax benefits from previous awards remaining in paid-in capital to which it can be offset.

The notes to financial statements of both public and nonpublic entities will disclose information to assist users of financial information to understand the nature of share-based payment transactions and the effects of those transactions on the financial statements.

How This Statement Changes Practice and Improves Financial Reporting

This Statement eliminates the alternative to use Opinion 25's intrinsic value method of accounting that was provided in Statement 123 as originally issued. Under Opinion 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This Statement requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). Recognition of that compensation cost helps users of financial statements to better understand the economic transactions affecting an entity and to make better resource allocation decisions. Such information specifically will help users of financial statements understand the effect that share-based compensation transactions have on an entity's financial condition and results of operations. This Statement also will improve comparability by eliminating one of two different methods of accounting for share-based compensation transactions and thereby also will simplify existing U.S. GAAP. Eliminating different methods of accounting for the same transactions leads to improved comparability of financial statements because similar economic transactions will be accounted for similarly.

The fair-value-based method in this Statement is similar to the fair-value-based method in Statement 123 in most respects. However, the following are the key differences between the two:

a. Public entities are required to measure liabilities incurred to employees in share-based payment transactions at fair value. Nonpublic entities may elect to measure their liabilities to employees incurred in share-based payment transactions at their intrinsic value. Under Statement 123, all share-based payment liabilities were measured at their intrinsic value.

b. Nonpublic entities are required to account for awards of equity instruments using the fair-value-based method unless it is not possible to reasonably estimate the grant-date fair value of awards of equity share options and similar instruments because it is not practicable to estimate the expected volatility of the entity's share price. In that situation, the entity will account for those instruments based on a value calculated by substituting the historical volatility of an appropriate industry sector index for the expected volatility of its share price. Statement 123 permitted a nonpublic entity to measure its equity awards using either the fair-value-based method or the minimum value method.

c. Entities are required to estimate the number of instruments for which the requisite service is expected to be rendered. Statement 123 permitted entities to account for forfeitures as they occur.

d. Incremental compensation cost for a modification of the terms or conditions of an award is measured by comparing the fair value of the modified award with the fair value of the award immediately before the modification. Statement 123 required that the effects of a modification be measured as the difference between the fair value of the modified award at the date it is granted and the award's value immediately before the modification determined based on the shorter of (1) its remaining initially estimated expected life or (2) the expected life of the modified award.

e. This Statement also clarifies and expands Statement 123's guidance in several areas, including measuring fair value, classifying an award as equity or as a liability, and attributing compensation cost to reporting periods.

In addition, this Statement amends FASB Statement No. 95, *Statement of Cash Flows*, to require that excess tax benefits be reported as a financing cash inflow rather than as a reduction of taxes paid.

How the Conclusions of This Statement Relate to the FASB's Conceptual Framework

FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, states that financial reporting should provide information that is useful in making business and economic decisions. Recognizing compensation cost incurred as a result of receiving employee services in exchange for valuable equity instruments issued by the employer will help achieve that objective by providing more relevant and reliable information about the costs incurred by the employer to obtain employee services in the marketplace.

FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, explains that comparability of financial information is important because information about an entity gains greatly in usefulness if it can be compared with similar information about other entities. Establishing the fair-value-based method of accounting as the required method will increase comparability because similar economic transactions will be accounted for similarly, which will improve the usefulness of financial information. Requiring the fair-value-based method also enhances the neutrality of the resulting financial reporting by eliminating the accounting bias toward using certain types of employee share options for compensation.

Completeness is identified in Concepts Statement 2 as an essential element of representational faithfulness and relevance. To faithfully represent the total cost of employee services to the entity, the cost of services received in exchange for awards of share-based compensation should be recognized in that entity's financial statements.

FASB Concepts Statement No. 6, *Elements of Financial Statements*, defines assets as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Employee services received in exchange for awards of share-based compensation qualify as assets, though only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the entity. This Statement will improve the accounting for an entity's assets resulting from receipt of employee services in exchange for an equity award by requiring that the cost of such assets either be charged to expense when consumed or capitalized as part of another asset of the entity (as permitted by U.S. GAAP).

Costs and Benefits

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. The Board's consideration of each issue in a project includes the subjective weighing of the incremental improvement in financial reporting against the incremental cost of implementing the identified alternatives. At the end of that process, the Board considers the accounting provisions in the aggregate and assesses the perceived benefits and the related perceived costs on a qualitative basis.

Several procedures were conducted before the issuance of this Statement to aid the Board in its assessment of the expected costs associated with implementing the required use of the fair-value-based accounting method. Those procedures included a review of the comment letters received on the Exposure Draft, a field visit program, a survey of commercial software providers, and discussions with members of the Option Valuation Group that the Board established to provide information and advice on how to improve the guidance in Statement 123 on measuring the fair value of share options and similar instruments issued to employees in compensation arrangements. That group included valuation experts from the compensation consulting, risk management, investment banking, and academic communities. The Board also discussed the issues in the project with other valuation experts, compensation consultants, and numerous other constituents. After considering the results of those cost-benefit procedures, the Board concluded that this Statement will sufficiently improve financial reporting to justify the costs it will impose.

The Effective Dates and Transition Requirements of This Statement

This Statement is effective:

a. For public entities that do not file as small business issuers—as of the beginning of the first

interim or annual reporting period that begins after June 15, 2005

b. For public entities that file as small business issuers—as of the beginning of the first interim or annual reporting period that begins after December 15, 2005

c. For nonpublic entities—as of the beginning of the first annual reporting period that begins after December 15, 2005.

This Statement applies to all awards granted after the required effective date and to awards modified, repurchased, or cancelled after that date. The cumulative effect of initially applying this Statement, if any, is recognized as of the required effective date.

As of the required effective date, all public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123 will apply this Statement using a modified version of prospective application. Under that transition method, compensation cost is recognized on or after the required effective date for the portion of outstanding awards for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards calculated under Statement 123 for either recognition or pro forma disclosures. For periods before the required effective date, those entities may elect to apply a modified version of retrospective application under which financial statements for prior periods are adjusted on a basis consistent with the pro forma disclosures required for those periods by Statement 123. Nonpublic entities that used the minimum value method in Statement 123 for either recognition or pro forma disclosures are required to apply the prospective transition method as of the required effective date.

Early adoption of this Statement for interim or annual periods for which financial statements or interim reports have not been issued is encouraged.

CONTENTS

INTRODUCTION

1. This Statement requires that the cost resulting from all **share-based payment transactions**[1] be recognized in the financial statements. This Statement establishes **fair value** as the measurement objective in accounting for **share-based payment arrangements** and requires all entities to apply a fair-value-based measurement method in accounting for share-based payment transactions with **employees** except for equity instruments held by **employee share ownership plans**. However, this Statement provides certain exceptions to that measurement method if it is not possible to reasonably estimate the fair value of an award at the **grant date**. A **nonpublic entity** also may choose to measure its liabilities under share-based payment arrangements at **intrinsic value**. This Statement also establishes fair value as the measurement objective for transactions in which an entity acquires goods or services from nonemployees in share-based payment transactions. This Statement uses the terms *compensation* and *payment* in their broadest senses to refer to the consideration paid for goods or services, regardless of whether the supplier is an employee.

2. This Statement amends FASB Statement No. 95, *Statement of Cash Flows*, to require that **excess tax benefits** be reported as a financing cash inflow rather than as a reduction of taxes paid.

3. This Statement replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. This Statement also supersedes or amends other pronouncements indicated in Appendix D.

[1] Terms defined in Appendix E, the glossary, are set in **boldface type** the first time they appear.

Appendix A is an integral part of this Statement and provides implementation guidance on measurement and recognition of compensation cost resulting from share-based payment arrangements with employees. Appendix B provides the basis for the Board's conclusions, and Appendix C provides background information. Appendix E defines certain terms as they are used in this Statement, and Appendix F indicates the effect of this Statement on the status of related authoritative literature, including American Institute of Certified Public Accountants (AICPA) literature, Emerging Issues Task Force (EITF) issues, and Statement 133 implementation issues.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

4. This Statement applies to all share-based payment transactions in which an entity acquires goods or services by **issuing** (or offering to issue) its shares, **share options**, or other equity instruments (except for equity instruments held by an employee share ownership plan)[2] or by incurring liabilities to an employee or other supplier (a) in amounts based, at least in part[3], on the price of the entity's shares or other equity instruments or (b) that require or may require **settlement** by issuing the entity's equity shares or other equity instruments.

Recognition Principle for Share-Based Payment Transactions

5. An entity shall recognize the goods acquired or services received in a share-based payment transaction when it obtains the goods or as services are received.[4] The entity shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria (paragraphs 28–35). As the goods or services are disposed of or consumed, the entity shall recognize the related cost. For example, when inventory is sold, the cost is recognized in the income statement as cost of goods sold, and as services are consumed, the cost usually is recognized in determining net income of that period, for example, as expenses incurred for employee services. In some circumstances, the cost of services (or goods) may be initially capitalized as part of the cost to acquire or construct another asset, such as inventory, and later recognized in the income statement when that asset is disposed of or consumed.[5]

6. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. For example, the rights and obligations embodied in a transfer of equity shares to an employee for a note that provides no recourse to other assets of the employee (that is, other than the shares) are substantially the same as those embodied in a grant of equity share options. Thus, that transaction shall be accounted for as a substantive grant of equity share options. The **terms** of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a **reload feature**, shall be reflected in determining the fair value of the equity or liability instruments granted. For example, the fair value of a substantive option structured as the exchange of equity shares for a nonrecourse note will differ depending on whether the employee is required to pay nonrefundable interest on the note. Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances.

Measurement Principle for Share-Based Payment Transactions

7. If the fair value of goods or services received in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the equity instruments issued, the fair value of the goods or services received shall be used to measure the transaction.[6] In contrast, if the fair value of the equity instruments issued in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the consideration received, the transaction shall be measured based on the fair value of the equity instruments issued. A share-based payment transaction with employees shall be measured based on the fair value (or in certain situations specified in this Statement, a **calculated value** or intrinsic value) of the equity instruments issued.

Measurement Date for Share-Based Payment Transactions with Nonemployees

8. This Statement does not specify the **measurement date** for share-based payment transactions with nonemployees for which the measure of the cost of goods acquired or services received is based on the fair value of the equity instruments issued. EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," establishes criteria for determining the measurement date for equity instruments issued in share-based payment transactions with nonemployees.

Accounting for Share-Based Payment Transactions with Employees

9. The objective of accounting for transactions under share-based payment arrangements with employees is to recognize in the financial statements the employee services received in exchange for equity instruments issued or liabilities incurred and the related cost to the entity as those services are consumed.

10. An entity shall account for the compensation cost from share-based payment transactions with employees in accordance with the fair-value-based method set forth in paragraphs 11–63 of this Statement. That is, the cost of services received from employees in exchange for awards[7] of share-based compensation generally shall be measured based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred. The fair value of liabilities incurred in share-based transactions with employees shall be remeasured at the end of each reporting period through settlement. Paragraphs 23–25 and 38 set forth exceptions to the fair-value-based measurement of awards of share-based employee compensation.

Certain Transactions with Related Parties and Other Economic Interest Holders

11. Share-based payments awarded to an employee of the reporting entity by a **related party** or other holder of an economic interest in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Statement unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

Employee Share Purchase Plans

12. An employee share purchase plan that satisfies all of the following criteria does not give rise to recognizable compensation cost (that is, the plan is noncompensatory):

a. The plan satisfies at least one of the following conditions:

(1) The terms of the plan are no more favorable than those available to all holders of the same class of shares.[8]

(2) Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. A purchase discount of 5 percent or less from the market price shall be considered to comply with this condition without

[2] AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans*, specifies the accounting by employers for employee share ownership plans.

[3] The phrase *at least in part* is used because an award of share-based compensation may be indexed to both the price of an entity's shares and something else that is neither the price of the entity's shares nor a market, performance, or service condition.

[4] An entity may need to recognize an asset before it actually receives goods or services if it first exchanges share-based payment for an enforceable right to receive those goods or services. Nevertheless, the goods or services themselves are not recognized before they are received.

[5] This Statement refers to recognizing *compensation cost* rather than *compensation expense* because any compensation cost that is capitalized as part of the cost to acquire or construct an asset would not be recognized as compensation expense in the income statement.

[6] The consideration received for issuing equity instruments, like the consideration involved in a repurchase of treasury shares, may include stated or unstated rights. FASB Technical Bulletin No. 85-6, *Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt*, provides pertinent guidance.

[7] This Statement uses the term *award* as the collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single employee or to a group of employees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected terms. Provisions of this Statement that refer to *an award* also apply to a portion of an award.

[8] A transaction subject to an employee share purchase plan that involves a class of equity shares designed exclusively for and held only by current or former employees or their beneficiaries may be compensatory depending on the terms of the arrangement.

further justification. A purchase discount greater than 5 percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount.[9]

b. Substantially all employees that meet limited employment qualifications may participate on an equitable basis.

c. The plan incorporates no option features, other than the following:

(1) Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

(2) The purchase price is based solely on the market price of the shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

13. A plan provision that establishes the purchase price as an amount based on the lesser of the equity share's market price at date of grant or its market price at date of purchase is an example of an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the share's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid contains an option feature that causes the plan to be compensatory. Illustrations 19 (paragraphs A211–A219) and 20 (paragraphs A220 and A221) provide guidance on determining whether an employee share purchase plan satisfies the criteria necessary to be considered noncompensatory.

14. The **requisite service period** for any compensation cost resulting from an employee share purchase plan is the period over which the employee participates in the plan and pays for the shares.

Measurement Principle for Share-Based Payment Transactions with Employees

15. The cost of services received by an entity as consideration for equity instruments issued or liabilities incurred in share-based compensation transactions with employees shall be measured based on the fair value of the equity instruments issued or the liabilities settled. The portion of the fair value of an instrument attributed to employee service is net of any amount that an employee pays (or becomes obligated to pay) for that instrument when it is granted. For example, if an employee pays $5 at the grant date for an option with a grant-date fair value of $50, the amount attributed to employee service is $45.

Measurement of Awards Classified as Equity

Measurement Objective and Measurement Date for Equity Awards

16. The measurement objective for equity instruments awarded to employees is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise share options). That estimate is based on the share price and other pertinent factors, such as expected **volatility**, at the grant date.

17. To satisfy the measurement objective in paragraph 16, the **restrictions** and conditions inherent in equity instruments awarded to employees are treated differently depending on whether they continue in effect after the requisite service period. A restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer **vested** equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date. For equity share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees' expected exercise and post-vesting employment termination behavior in estimating fair value (referred to as an option's *expected term*).

18. In contrast, a restriction that stems from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested equity share option or to sell **nonvested shares**, is not reflected in estimating the fair value of the related instruments at the grant date. Instead, those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.

19. Awards of share-based employee compensation ordinarily specify a **performance condition** or a **service condition** (or both) that must be satisfied for an employee to earn the right to benefit from the award. No compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied (that is, instruments for which the requisite service is not rendered). Some awards contain a **market condition**. The effect of a market condition is reflected in the grant-date fair value of an award.[10] Compensation cost thus is recognized for an award with a market condition provided that the requisite service is rendered, regardless of when, if ever, the market condition is satisfied. Illustrations 4 (paragraphs A86–A104), 5 (paragraphs A105–A110), and 10 (paragraphs A127–A133) provide examples of how compensation cost is recognized for awards with service and performance conditions.

20. The fair-value-based method described in paragraphs 16–19 uses fair value measurement techniques, and the grant-date share price and other pertinent factors are used in applying those techniques. However, the effects on the grant-date fair value of service and performance conditions that apply only during the requisite service period are reflected based on the outcomes of those conditions. The remainder of this Statement refers to the required measure as fair value.

Nonvested and Restricted Equity Shares

21. A nonvested equity share or nonvested equity **share unit** awarded to an employee shall be measured at its fair value as if it were vested and issued on the grant date. A **restricted share**[11] awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount for which a similarly restricted share would be issued to third parties. Illustration 11(a) (paragraphs A134–A136) provides an example of accounting for an award of nonvested shares.

Equity Share Options

22. The fair value of an equity share option or similar instrument shall be measured based on the observable market price of an option with the same or similar terms and conditions, if one is available (paragraph A7).[12] Otherwise, the fair value of an equity share option or *similar instrument* shall be estimated using a valuation technique such as an option-pricing model. For this purpose, a *similar instrument* is one whose fair value differs from its intrinsic value, that is, an instrument that has **time value**. For example, a share appreciation right (SAR) that requires net settlement in equity shares has time value; an equity share does not. Paragraphs A2–A42 provide additional guidance on estimating the fair value of equity instruments, including the factors to be taken into account in estimating the fair value of equity share options or similar instruments as described in paragraph A18.

Equity Instruments for Which It Is Not Possible to Reasonably Estimate Fair Value at the Grant Date

Equity instruments granted by a nonpublic entity for which it is not possible to reasonably estimate fair value at the grant date because it is not practicable to estimate the expected volatility of the entity's share price

23. A nonpublic entity may not be able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value).[13] Paragraphs A43–A48 and Illustration 11(b) (paragraphs A137–A142) provide additional guidance on applying the calculated value method to equity share options and similar instruments granted by a nonpublic entity.

Equity instruments with terms that make it not possible to reasonably estimate fair value at the grant date

24. It should be possible to reasonably estimate the fair value of most equity share options and other equity instruments at the date they are

[9] An entity that justifies a purchase discount in excess of 5 percent shall reassess at least annually, and no later than the first share purchase offer during the fiscal year, whether it can continue to justify that discount pursuant to paragraph 12(a)(2) of this Statement.

[10] Valuation techniques have been developed to value path-dependent options as well as other options with complex terms. Awards with market conditions, as defined in this Statement, are path-dependent options.

[11] Nonvested shares granted to employees usually are referred to as *restricted shares*, but this Statement reserves that term for fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.

[12] As of the issuance of this Statement, such market prices for equity share options and similar instruments granted to employees are generally not available; however, they may become so in the future.

[13] Throughout the remainder of this Statement, provisions that apply to accounting for share options and similar instruments at fair value also apply to calculated value.

granted. Appendix A illustrates techniques for estimating the fair values of several instruments with complicated features. However, in rare circumstances, it may not be possible to reasonably estimate the fair value of an equity share option or other equity instrument at the grant date because of the complexity of its terms.

25. An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be accounted for based on its intrinsic value, remeasured at each reporting date through the date of exercise or other settlement. The final measure of compensation cost shall be the intrinsic value of the instrument at the date it is settled. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the intrinsic value of the instrument in each reporting period. The entity shall continue to use the intrinsic value method for those instruments even if it subsequently concludes that it is possible to reasonably estimate their fair value.

Reload Options and Contingent Features

26. The fair value of each award of equity instruments, including an award of options with a reload feature (reload options), shall be measured separately based on its terms and the share price and other pertinent factors at the grant date. The effect of a reload feature in the terms of an award shall not be included in estimating the grant-date fair value of the award. Rather, a subsequent grant of reload options pursuant to that provision shall be accounted for as a separate award when the reload options are granted.

27. A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature (paragraph A5, footnote 44), shall not be reflected in estimating the grant-date fair value of an equity instrument. Instead, the effect of such a contingent feature shall be accounted for if and when the contingent event occurs.

Awards Classified as Liabilities

Criteria for Classifying Awards as Liabilities

28. Paragraphs 29–35 of this Statement provide guidance for determining whether certain financial instruments awarded in share-based payment transactions are liabilities. In determining whether an instrument not specifically discussed in paragraphs 29–35 should be classified as a liability or as equity, an entity shall apply generally accepted accounting principles (GAAP) applicable to financial instruments issued in transactions not involving share-based payment.

Applying the classification criteria in Statement 150

29. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, excludes from its scope instruments that are accounted for under this Statement. Nevertheless, unless paragraphs 30–35 of this Statement require otherwise, an entity shall apply the classification criteria in paragraphs 8–14 of Statement 150, as they are effective at the reporting date, in determining whether to classify as a liability a **freestanding financial instrument** given to an employee in a share-based payment transaction. Paragraphs A230–A232 of this Statement provide criteria for determining when instruments subject to this Statement subsequently become subject to Statement 150 or to other applicable GAAP.

30. In determining the classification of an instrument, an entity shall take into account the deferrals contained in FSP FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*." In addition, a call option[14] written on an instrument that is not classified as a liability because of the deferrals in FSP FAS 150-3 (for example, a call option on a mandatorily redeemable share for which liability classification is deferred under FSP FAS 150-3) also shall be classified as equity while the deferral is in effect unless liability classification is required under the provisions of paragraph 32 of this Statement.

Classification of certain awards with repurchase features

31. Statement 150 does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A puttable (or callable) share[15] awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met: (a) the repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the requisite service is rendered and the share is issued,[16,17] or (b) it is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued. For this purpose, a period of six months or more is a *reasonable period of time*. A puttable (or callable) share that does not meet either of those conditions shall be classified as equity.[18]

32. Options or similar instruments on shares shall be classified as liabilities if (a) the underlying shares are classified as liabilities or (b) the entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. For example, an entity may grant an option to an employee that, upon exercise, would be settled by issuing a mandatorily redeemable share that is not subject to the deferral in FSP FAS 150-3. Because the mandatorily redeemable share would be classified as a liability under Statement 150, the option also would be classified as a liability.

Awards with conditions other than market, performance, or service conditions

33. An award may be indexed to a factor in addition to the entity's share price. If that additional factor is not a market, performance, or service condition, the award shall be classified as a liability for purposes of this Statement, and the additional factor shall be reflected in estimating the fair value of the award.[19] Paragraph A53 provides examples of such awards.

Evaluating the terms of a share-based payment award in determining whether it qualifies as a liability

34. The accounting for an award of share-based payment shall reflect the substantive terms of the award and any related arrangement. Generally, the written terms provide the best evidence of the substantive terms of an award. However, an entity's past practice may indicate that the substantive terms of an award differ from its written terms. For example, an entity that grants a **tandem award** under which an employee receives either a stock option or a cash-settled SAR is obligated to pay cash on demand if the choice is the employee's, and the entity thus incurs a liability to the employee. In contrast, if the choice is the entity's, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an entity that nominally has the choice of settling awards by issuing stock predominately settles in cash, or if the entity usually settles in cash whenever an employee asks for cash settlement, the entity is settling a substantive liability rather than repurchasing an equity instrument. In determining whether an entity that has the choice of settling an award by issuing equity shares has a substantive liability, the entity also shall consider whether (a) it has the ability to deliver the shares[20] and (b) it is required to pay cash if a contingent event occurs (paragraph 32).

[14] Refer to the definition of *share option* in Appendix E.

[15] A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares.

[16] A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet condition (a) until it becomes probable that the event will occur within the reasonable period of time.

[17] An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered.

[18] SEC registrants are required to consider the guidance in ASR No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks."* Under that guidance, shares subject to mandatory redemption requirements or whose redemption is outside the control of the issuer are classified outside permanent equity.

[19] For this purpose, an award of equity share options granted to an employee of an entity's foreign operation that provides for a fixed exercise price denominated either in the foreign operation's functional currency or in the currency in which the employee's pay is denominated shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award is not required to be classified as a liability if it otherwise qualifies as equity. For example, equity share options with an exercise price denominated in Euros granted to employees of a U.S. entity's foreign operation whose functional currency is the Euro are not required to be classified as liabilities if those options otherwise qualify as equity. In addition, such options are not required to be classified as liabilities even if the functional currency of the foreign operation is the U.S. dollar, provided that the employees to whom the options are granted are paid in Euros.

[20] Federal securities law generally requires that transactions involving offerings of shares under employee share option arrangements be registered, unless there is an available exemption. For purposes of this Statement, such requirements do not, by themselves, imply that an entity does not have the ability to deliver shares and thus do not require an award that otherwise qualifies as equity to be classified as a liability.

Broker-assisted cashless exercises and minimum statutory withholding requirements

35. A provision that permits employees to effect a **broker-assisted cashless exercise** of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:[21]

a. The cashless exercise requires a valid exercise of the share options.

b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option).

Similarly, a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer's minimum statutory withholding requirements[22] resulting from the exercise, does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. However, if an amount in excess of the minimum statutory requirement is withheld, or may be withheld at the employee's discretion, the entire award shall be classified and accounted for as a liability.

Measurement Objective and Measurement Date for Liabilities

36. At the grant date, the measurement objective for liabilities incurred under share-based compensation arrangements is the same as the measurement objective for equity instruments awarded to employees as described in paragraph 16. However, the measurement date for liability instruments is the date of settlement. Accordingly, liabilities incurred under share-based payment arrangements are remeasured at the end of each reporting period until settlement.

Measurement of liability awards of public entities

37. A **public entity** shall measure a liability award under a share-based payment arrangement based on the award's fair value remeasured at each reporting date until the date of settlement. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the fair value of the instrument for each reporting period. Illustration 10 (paragraphs A127–A133) provides an example of accounting for an instrument classified as a liability using the fair-value-based method.

Measurement of liability awards of nonpublic entities

38. A nonpublic entity shall make a policy decision of whether to measure all of its liabilities incurred under share-based payment arrangements at fair value or to measure all such liabilities at intrinsic value.[23] Regardless of the method selected, a nonpublic entity shall remeasure its liabilities under share-based payment arrangements at each reporting date until the date of settlement. The fair-value-based method is preferable for purposes of justifying a change in accounting principle under APB Opinion No. 20, *Accounting Changes*. Illustration 10 (paragraphs A127–A133) provides an example of accounting for an instrument classified as a liability using the fair-value-based method. Illustration 11(c) (paragraphs A143–A148) provides an example of accounting for an instrument classified as a liability using the intrinsic value method.

Recognition of Compensation Cost for an Award Accounted for as an Equity Instrument

Recognition of Compensation Cost over the Requisite Service Period

39. The compensation cost for an award of share-based employee compensation classified as equity shall be recognized over the requisite service period, with a corresponding credit to equity (generally, paid-in capital). The requisite service period is the period during which an employee is required to provide service in exchange for an award, which often is the vesting period. The requisite service period is estimated based on an analysis of the terms of the share-based payment award.

40. The requisite service period may be explicit or it may be implicit, being inferred from an analysis of other terms in the award, including other explicit service or performance conditions. The requisite service period for an award that contains a market condition can be derived from certain valuation techniques that may be used to estimate grant-date fair value (paragraph A60). An award may have one or more **explicit, implicit,** or **derived service periods;** however, an award may have only one requisite service period for accounting purposes unless it is accounted for as in-substance multiple awards.[24] Paragraphs A59–A74 provide guidance on estimating the requisite service period and provide examples of how that period should be estimated if an award's terms include more than one explicit, implicit, or derived service period.

41. The **service inception date** is the beginning of the requisite service period. If the service inception date precedes the grant date (paragraph A79), accrual of compensation cost for periods before the grant date shall be based on the fair value of the award at the reporting date. In the period in which the grant date occurs, cumulative compensation cost shall be adjusted to reflect the cumulative effect of measuring compensation cost based on fair value at the grant date rather than the fair value previously used at the service inception date (or any subsequent reporting date). Illustration 3 (paragraphs A79–A85) provides guidance on the concept of *service inception date* and how it is to be applied.

42. An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule (a) on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards or (b) on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award). However, the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date. Illustration 4(b) (paragraphs A97–A104) provides an example of the accounting for an award with a graded vesting schedule.

Amount of Compensation Cost to Be Recognized over the Requisite Service Period

43. The total amount of compensation cost recognized at the end of the requisite service period for an award of share-based compensation shall be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed). An entity shall base initial accruals of compensation cost on the estimated number of instruments for which the requisite service is expected to be rendered. That estimate shall be revised if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the requisite service is expected to be or has been rendered shall be recognized in compensation cost in the period of the change.

44. Accruals of compensation cost for an award with a performance condition shall be based on the probable[25] outcome of that performance condition—compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved. If an award has multiple performance conditions (for example, if the number of options or shares an employee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost shall be accrued if it is probable that a performance condition will be satisfied. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions. Illustration 5 (paragraphs A105–A110) provides an example of how to account for awards with multiple performance conditions.

45. Previously recognized compensation cost shall not be reversed if an employee share option (or share unit) for which the requisite ser-

[21] A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

[22] Minimum statutory withholding requirements are to be based on the applicable minimum statutory withholding rates required by the relevant tax authority (or authorities, for example, federal, state, and local), including the employee's share of payroll taxes that are applicable to such supplemental taxable income.

[23] Consistent with the guidance in paragraph 23, footnote 13, a nonpublic entity that is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price shall make a policy choice of whether to measure its liabilities under share-based payment arrangements at calculated value or at intrinsic value.

[24] An award with a graded vesting schedule that is accounted for as in-substance multiple awards is an example of an award that has more than one requisite service period (paragraph 42).

[25] *Probable* is used in the same sense as in FASB Statement No. 5, *Accounting for Contingencies:* "the future event or events are likely to occur" (paragraph 3).

vice has been rendered expires unexercised (or unconverted).

Estimating the Requisite Service Period

46. An entity shall make its initial best estimate of the requisite service period at the grant date (or at the service inception date if that date precedes the grant date) and shall base accruals of compensation cost on that period. An entity shall adjust that initial best estimate in light of changes in facts and circumstances. The initial best estimate and any subsequent adjustment to that estimate of the requisite service period for an award with a combination of market, performance, or service conditions shall be based on an analysis of (a) all vesting and exercisability conditions, (b) all explicit, implicit, and derived service periods, and (c) the probability that performance or service conditions will be satisfied. For such an award, whether and how the initial best estimate of the requisite service period is adjusted depends on both the nature of those conditions and the manner in which they are combined, for example, whether an award vests or becomes exercisable when either a market or a performance condition is satisfied or whether both conditions must be satisfied. Paragraphs A59–A66 provide guidance on adjusting the initial estimate of the requisite service period.

Effect of Market, Performance, and Service Conditions on Recognition and Measurement of Compensation Cost

Market, performance, and service conditions that affect vesting or exercisability

47. If an award requires satisfaction of one or more market, performance, or service conditions (or any combination thereof), compensation cost is recognized if the requisite service is rendered, and no compensation cost is recognized if the requisite service is not rendered. Paragraphs A49–A51 provide guidance on applying this provision to awards with market, performance, or service conditions (or any combination thereof).

48. Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date because those conditions are restrictions that stem from the forfeitability of instruments to which employees have not yet earned the right. However, the effect of a market condition is reflected in estimating the fair value of an award at the grant date (paragraph 19). For purposes of this Statement, a market condition is not considered to be a vesting condition, and an award is not deemed to be forfeited solely because a market condition is not satisfied. Accordingly, an entity shall reverse previously recognized compensation cost for an award with a market condition only if the requisite service is not rendered.

Market, performance, and service conditions that affect factors other than vesting or exercisability

49. Market, performance, and service conditions (or any combination thereof) may affect an award's exercise price, contractual term, quantity, conversion ratio, or other factors that are considered in measuring an award's grant-date fair value. A grant-date fair value shall be estimated for each possible outcome of such a performance or service condition, and the final measure of compensation cost shall be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied. Paragraphs A52–A54 provide additional guidance on the effects of market, performance, and service conditions that affect factors other than vesting or exercisability. Illustrations 5 (paragraphs A105–A110), 6 (paragraphs A111–A113), and 8 (paragraphs A121–A124) provide examples of accounting for awards with such conditions.

Recognition of Changes in the Fair Value or Intrinsic Value of Awards Classified as Liabilities

50. Changes in the fair value (or intrinsic value for a nonpublic entity that elects that method) of a liability incurred under a share-based payment arrangement that occur during the requisite service period shall be recognized as compensation cost over that period. The percentage of the fair value (or intrinsic value) that is accrued as compensation cost at the end of each period shall equal the percentage of the requisite service that has been rendered at that date. Changes in the fair value (or intrinsic value) of a liability that occur after the end of the requisite service period are compensation cost of the period in which the changes occur. Any difference between the amount for which a liability award is settled and its fair value at the settlement date as estimated in accordance with the provisions of this Statement is an adjustment of compensation cost in the period of settlement. Illustration 10 (paragraphs A127–A133) provides an example of accounting for a liability award from the grant date through its settlement.

Modifications of Awards of Equity Instruments

51. A **modification** of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award.[26] In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for any incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Statement over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date.[27] The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraphs 43–45 and other guidance in Illustration 13 (paragraphs A160–A170).

b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be (1) the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus (2) the incremental cost resulting from the modification. Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraphs 43–45 and other guidance in Illustration 13 (paragraphs A160–A170).

c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 25 shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.

Illustrations 12–14 (paragraphs A149–A189) provide additional guidance on, and illustrate the accounting for, modifications of both vested and nonvested awards, including a modification that changes the classification of the related financial instruments from equity to liability or vice versa, and modifications of vesting conditions. Illustration 22 (paragraphs A225–A232) provides additional guidance on accounting for modifications of certain freestanding financial instruments that initially were subject to this Statement but subsequently became subject to other applicable GAAP.

Inducements

52. A **short-term inducement** shall be accounted for as a modification of the terms of only the awards of employees who accept the inducement. Other inducements are modifications of the terms of all awards subject to them and shall be accounted for as such.

Equity Restructurings

53. Exchanges of share options or other equity instruments or changes to their terms in conjunction with an **equity restructuring** or a business combination are modifications for purposes of this Statement.

54. Except for a modification to add an antidilution provision that is not made in contemplation of an equity restructuring, accounting for a modification in conjunction with an equity restructuring requires a comparison of the fair value of the modified award with the fair value of the original award immediately before the modification in accordance with paragraph 51. If those amounts are the same, for instance, because the modification is designed to equalize the fair value of an award before and after an equity restructuring, no incremental compensation cost is recognized. Illustration 12(e) (paragraphs A156–A159) provides further guidance on applying the provisions of this paragraph.

Repurchases or Cancellations of Awards of Equity Instruments

55. The amount of cash or other assets transferred (or liabilities incurred) to repurchase an

[26] A modification of a liability award also is accounted for as the exchange of the original award for a new award. However, because liability awards are remeasured at their fair value (or intrinsic value for a nonpublic entity that elects that method) at each reporting date, no special guidance is necessary in accounting for a modification of a liability award that remains a liability after the modification.

[27] As indicated in paragraph 23, footnote 13, references to *fair value* throughout paragraphs 24–85 of this Statement should be read also to encompass *calculated value*.

equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost. An entity that repurchases an award for which the requisite service has not been rendered has, in effect, modified the requisite service period to the period for which service already has been rendered, and thus the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date.

Cancellation and Replacement of Awards of Equity Instruments

56. Cancellation of an award accompanied by the concurrent grant of (or offer to grant)[28] a **replacement award** or other valuable consideration shall be accounted for as a modification of the terms of the cancelled award. Therefore, incremental compensation cost shall be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the cancelled award at the cancellation date in accordance with paragraph 51. Thus, the total compensation cost measured at the date of a cancellation and replacement shall be the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus the incremental cost resulting from the cancellation and replacement.

57. A cancellation of an award that is not accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a repurchase for no consideration. Accordingly, any previously unrecognized compensation cost shall be recognized at the cancellation date.

Accounting for Tax Effects of Share-Based Compensation Awards

58. Income tax regulations specify allowable tax deductions for instruments issued under share-based payment arrangements in determining an entity's income tax liability. For example, under U.S. tax law at the issuance date of this Statement, allowable tax deductions are generally measured as the intrinsic value of an instrument on a specified date. The time value component, if any, of the fair value of an instrument generally is not tax deductible. Therefore, tax deductions generally will arise in different amounts and in different periods from compensation cost recognized in financial statements.

59. The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying FASB Statement No. 109, *Accounting for Income Taxes*. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. The deferred tax benefit (or expense) that results from increases (or decreases) in that temporary difference, for example, an increase that results as additional service is rendered and the related cost is recognized or a decrease that results from forfeiture of an award, shall be recognized in the income statement.[29] Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference in applying Statement 109. A future event, such as an employee's disqualifying disposition of shares under U.S. tax law at the issuance date of this Statement, can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs.

60. The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes.

61. Statement 109 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized.[30] Differences between (a) the deductible temporary difference computed pursuant to paragraph 59 of this Statement and (b) the tax deduction that would result based on the current fair value of the entity's shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under this Statement.

62. If a deduction reported on a tax return for an award of equity instruments exceeds the cumulative compensation cost for those instruments recognized for financial reporting, any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for those instruments (the excess tax benefit) shall be recognized as additional paid-in capital.[31] However, an excess of a realized tax benefit for an award over the deferred tax asset for that award shall be recognized in the income statement to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes.

63. The amount deductible on the employer's tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. The write-off of a deferred tax asset related to that deficiency, net of the related valuation allowance, if any, shall first be offset to the extent of any remaining additional paid-in capital from excess tax benefits from previous awards accounted for in accordance with this Statement or Statement 123. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in the income statement. An entity that continued to use Opinion 25's intrinsic value method as permitted by Statement 123 shall calculate the amount available for offset as the net amount of excess tax benefits that would have qualified as such had it instead adopted Statement 123 for recognition purposes pursuant to Statement 123's original effective date and transition method. In determining that amount, no distinction shall be made between excess tax benefits attributable to different types of equity awards, such as restricted shares or share options. An entity shall exclude from that amount both excess tax benefits from share-based payment arrangements that are outside the scope of this Statement, such as employee share ownership plans, and excess tax benefits that have not been realized pursuant to Statement 109, as noted in paragraph A94, footnote 82, of this Statement. Illustrations 4(a) (paragraphs A94–A96), 10 (paragraphs A132 and A133), 11(a) (paragraphs A135 and A136), and 14(a) (paragraphs A178–A180) of this Statement provide examples of accounting for the income tax effects of various awards.

Disclosures

64. An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand:

a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders

b. The effect of compensation cost arising from share-based payment arrangements on the income statement

c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period

d. The cash flow effects resulting from share-based payment arrangements.

Paragraphs A240 and A241 indicate the minimum information needed to achieve those objectives and illustrate how the disclosure requirements might be satisfied. In some circumstances, an entity may need to disclose information beyond that listed in paragraph A240 to achieve the disclosure objectives.

65. An entity that acquires goods or services other than employee services in share-based payment transactions shall provide disclosures similar to those required by paragraph 64 to the extent that those disclosures are important to an understanding of the effects of those transactions on the financial statements. In addition, an entity that has multiple share-based payment arrangements with employees shall disclose information separately for different types of awards under those arrangements to the extent that differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation (paragraph A240). *(continued on page 102)*

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[28] The phrase *offer to grant* is intended to cover situations in which the service inception date precedes the grant date.

[29] Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

[30] Paragraph 21 of Statement 109 states, "Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law." That paragraph goes on to describe the four sources of taxable income that may be available under the tax law to realize a tax benefit for deductible temporary differences and carry forwards.

[31] If only a portion of an award is exercised, determination of the excess tax benefits shall be based on the portion of the award that is exercised.

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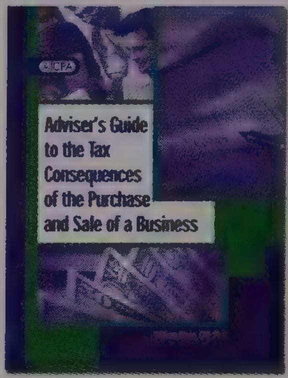

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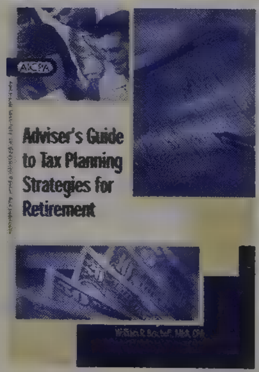

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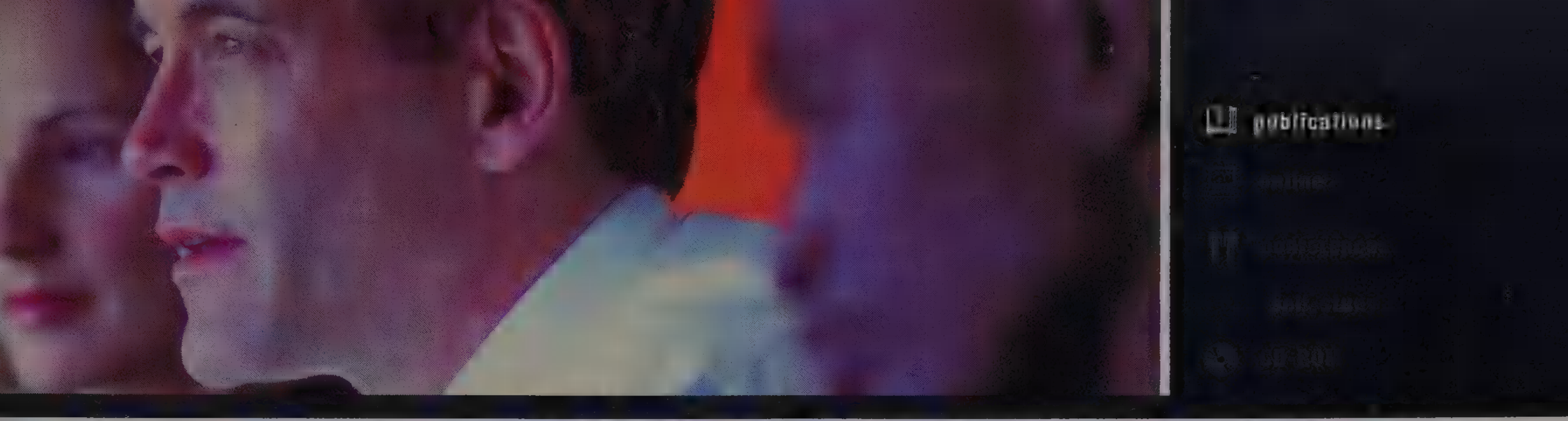

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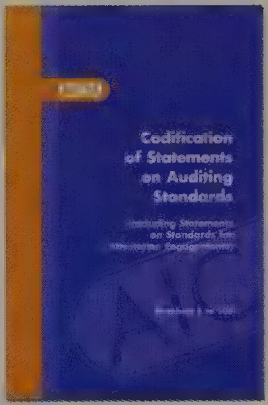

This book, created for auditors of non-public companies, is codified with all amendments and conforming changes as of January 1, 2005, giving you the most up-to-date guidance. All **AICPA Statements on Auditing Standards** (SASs), **Statements on Standards for Attestation Engagements** (SSAEs), and related interpretations are conveniently organized so that the information can be located quickly and easily. The pronouncements are indexed by subject, with amendments noted and superseded portions deleted. You'll find these updates — and more — in the 2005 edition:

- Auditing Interpretations No. 17 and No. 18 of SAS No. 58, *Reports on Audited Financial Statements*, titled "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," and "Reference to PCAOB Standards in an Audit Report on a Nonissuer"
- Revision of Auditing Interpretations No. 12 and No. 14 of SAS No. 62, *Special Reports*, titled "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," and "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" (formerly titled, "Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting")
- Auditing Interpretation No. 15 of SAS No. 62, titled "Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request"
- Auditing Interpretation No. 1 of SAS No. 50, *Reports on the Application of Accounting Principles*, titled "Requirement to Consult With the Continuing Accountant"
- Attest Engagements Interpretation No. 6 of SSAE No. 10, Chapter 1, *Attest Engagements*, titled "Reporting on Attestation Engagements Performed in Accordance With *Government Auditing Standards*"

In addition, conforming and editorial changes have been made throughout the literature to reflect the issuance of Statement on Standards for Accounting and Review Services No. 10, *Performance of Review Engagements*.

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Earnings per Share Implications

66. FASB Statement No. 128, *Earnings per Share*, requires that employee equity share options, nonvested shares, and similar equity instruments granted to employees be treated as potential common shares in computing diluted earnings per share. Diluted earnings per share shall be based on the actual number of options or shares granted and not yet forfeited, unless doing so would be antidilutive. If vesting in or the ability to exercise (or retain) an award is contingent on a performance or market condition, such as the level of future earnings, the shares or share options shall be treated as contingently issuable shares in accordance with paragraphs 30–35 of Statement 128. If equity share options or other equity instruments are outstanding for only part of a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments are outstanding.

67. Paragraphs 21–23 of Statement 128 provide guidance on applying the treasury stock method for equity instruments granted in share-based payment transactions in determining diluted earnings per share.

Amendments to Statement 95

68. Statement 95 is amended by adding the underlined wording as follows:

a. Paragraph 19, as amended by FASB Statements No. 117, *Financial Statements of Not-for-Profit Organizations*, and No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities:*

Cash inflows from financing activities are:

a. Proceeds from issuing equity instruments

b. Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing

c. Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a permanent endowment or term endowment

d. Proceeds received[7a] from derivative instruments that include financing elements[7b] at inception

e. Cash retained as a result of the tax deductibility of increases in the value of equity instruments issued under share-based payment arrangements that are not included in the cost of goods or services that is recognizable for financial reporting purposes. For this purpose, excess tax benefits shall be determined on an individual award (or a portion thereof) basis.

b. Paragraph 23 as amended by FASB Statements No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, and No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections:*

Cash outflows for operating activities are:

a. Cash payments to acquire materials for manufacture or goods[8d] for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods.

b. Cash payments to other suppliers and employees for other goods or services.

c. Cash payments to governments for taxes, duties, fines, and other fees or penalties and the cash that would have been paid for income taxes if increases in the value of equity instruments issued under share-based payment arrangements that are not included in the cost of goods or services recognizable for financial reporting purposes also had not been deductible in determining taxable income. (This is the same amount reported as a financing cash inflow pursuant to paragraph 19(e) of this Statement.)

d. Cash payments to lenders and other creditors for interest.

e. All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

c. Paragraph 27, as amended by Statement 117:

In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method). Enterprises that do so should, at a minimum, separately report the following classes of operating cash receipts and payments:[11]

a. Cash collected from customers, including lessees, licensees, and the like

b. Interest and dividends received[11a]

c. Other operating cash receipts, if any

d. Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like

e. Interest paid

f. Income taxes paid and, separately, the cash that would have been paid for income taxes if increases in the value of equity instruments issued under share-based payment arrangements that are not recognizable as a cost of goods or services for accounting purposes also had not been deductible in determining taxable income (paragraph 19(e))

g. Other operating cash payments, if any.

Enterprises are encouraged to provide further breakdowns of operating cash receipts and payments that they consider meaningful and feasible. For example, a retailer or manufacturer might decide to further divide cash paid to employees and suppliers (category (d) above) into payments for costs of inventory and payments for selling, general, and administrative expenses.

Effective Dates and Transition

69. This Statement is effective:

a. For public entities that do not file as **small business issuers**—as of the beginning of the first interim or annual reporting period that begins after June 15, 2005

b. For public entities that file as small business issuers—as of the beginning of the first interim or annual reporting period that begins after December 15, 2005

c. For nonpublic entities—as of the beginning of the first annual reporting period that begins after December 15, 2005.

The effective date for a nonpublic entity that becomes a public entity after June 15, 2005, and does not file as a small business issuer is the first interim or annual reporting period beginning after the entity becomes a public entity. If the newly public entity files as a small business issuer, the effective date is the first interim or annual reporting period beginning after December 15, 2005, for which the entity is a public entity.

70. This Statement applies to all awards granted after the required effective date. This Statement shall not be applied to awards granted in periods before the required effective date except to the extent that prior periods' awards are modified, repurchased, or cancelled after the required effective date and as required by paragraph 74. The cumulative effect of initially applying this Statement, if any, shall be recognized as of the required effective date (paragraphs 79–82).

71. As of the required effective date, all public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123 shall apply the modified prospective application transition method (paragraphs 74 and 75). For periods before the required effective date, those entities may elect to apply the modified retrospective application transition method (paragraphs 76–78).

72. Nonpublic entities that used the minimum value method in Statement 123 for either recognition or pro forma disclosures are required to apply the prospective transition method (paragraph 83) as of the required effective date.

73. Early adoption of this Statement for interim or annual periods for which financial statements or interim reports have not been issued is encouraged.[32]

Modified Prospective Application

74. As of the required effective date, all public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123, including such nonpublic entities that become public entities after June 15, 2005, shall adopt this Statement using a modified version of prospective application (*modified prospective application*). Under modified prospective application, this Statement applies to new awards and to awards modified, repurchased, or cancelled after the required effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the required effective date shall be recognized as the requisite service is rendered on or after the required effective date. The compensation cost for that portion of awards shall be based on the grant-date fair value of those awards as calculated for either recognition or pro forma disclosures under Statement 123. Changes to the grant-date fair value of equity awards granted before the required effective date of this Statement are precluded.[33] The compensation cost for those earlier awards shall be attributed to periods beginning on or after the required effective date of this Statement using the attribution method that was used under Statement 123, except that the method of recognizing forfeitures only as they occur shall not be continued (paragraph

[32] If an entity early adopts this Statement pursuant to paragraph 73, then the *required effective date* would be the first date in the initial period of adoption.

[33] The prohibition in paragraphs 74 and 76 of changes to the grant-date fair value of equity awards granted before the required effective date of this Statement does not apply if the entity needs to correct an error.

80). Any unearned or deferred compensation (contra-equity accounts) related to those earlier awards shall be eliminated against the appropriate equity accounts.

75. An entity that does not choose modified retrospective application (paragraphs 76–78 of this Statement) shall apply the amendments to Statement 95 in paragraph 68 of this Statement only for the interim or annual periods for which this Statement is adopted.

Modified Retrospective Application

76. All public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123, including such nonpublic entities that become public entities after June 15, 2005, may apply a modified version of retrospective application (*modified retrospective application*) to periods before the required effective date. Modified retrospective application may be applied either (a) to all prior years for which Statement 123 was effective[34] or (b) only to prior interim periods in the year of initial adoption if the required effective date of this Statement does not coincide with the beginning of the entity's fiscal year. An entity that chooses to apply the modified retrospective method to all prior years for which Statement 123 was effective shall adjust financial statements for prior periods to give effect to the fair-value-based method of accounting for awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, on a basis consistent with the pro forma disclosures required for those periods by Statement 123, as amended by FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*,[35] and by paragraph 30 of APB Opinion No. 28, *Interim Financial Reporting*. Accordingly, compensation cost and the related tax effects will be recognized in those financial statements as though they had been accounted for under Statement 123.[36] Changes to amounts as originally measured on a pro forma basis are precluded.

77. If an entity applies the modified retrospective application method to all prior years for which Statement 123 was effective and does not present all of those years in comparative financial statements, the beginning balances of paid-in capital, deferred taxes, and retained earnings for the earliest year presented shall be adjusted to reflect the results of modified retrospective application to those prior years not presented. The effects of any such adjustments shall be disclosed in the year of adoption. If an entity applies the modified retrospective application method only to prior interim periods in the year of initial adoption, there would be no adjustment to the beginning balances of paid-in capital, deferred taxes, or retained earnings for the year of initial adoption.

78. The amendments to Statement 95 in paragraph 68 of this Statement shall be applied to the same periods for which the modified retrospective application method is applied.

Transition as of the Required Effective Date for both Modified Prospective and Modified Retrospective Transition Methods

79. Transition as of the required effective date for instruments that are liabilities under the provisions of this Statement shall be as follows:

a. For an instrument that had been classified as equity but is classified as a liability under this Statement, recognize a liability at its fair value (or portion thereof, if the requisite service has not been rendered). If (1) the fair value (or portion thereof) of the liability is greater or less than (2) previously recognized compensation cost for the instrument, the liability shall be recognized first, by reducing equity (generally, paid-in capital) to the extent of such previously recognized cost and second, by recognizing the difference (that is, the difference between items (1) and (2)) in the income statement, net of any related tax effect, as the cumulative effect of a change in accounting principle.

b. For an outstanding instrument that previously was classified as a liability and measured at intrinsic value, recognize the effect of initially measuring the liability at its fair value, net of any related tax effect, as the cumulative effect of a change in accounting principle.[37]

80. As of the required effective date, an entity that had a policy of recognizing the effect of forfeitures only as they occurred shall estimate the number of outstanding instruments for which the requisite service is not expected to be rendered. Balance sheet amounts related to any compensation cost (excluding nonrefundable dividend payments), net of related tax effects, for those instruments previously recognized in income because of that policy for periods before the effective date of this Statement shall be eliminated and recognized in income as the cumulative effect of a change in accounting principle as of the required effective date.

81. Except as required by paragraph 80, no transition adjustment as of the required effective date shall be made for any deferred tax assets associated with outstanding equity instruments that continue to be accounted for as equity instruments under this Statement. For purposes of calculating the available excess tax benefits if deferred tax assets need to be written off in subsequent periods, an entity shall include as available for offset only the net excess tax benefits that would have qualified as such had the entity adopted Statement 123 for recognition purposes for all awards granted, modified, or settled in cash for fiscal years beginning after December 15, 1994. In determining that amount, an entity shall exclude excess tax benefits that have not been realized pursuant to Statement 109 (paragraph A94, footnote 82, of this Statement). An entity that previously has recognized deferred tax assets for excess tax benefits prior to their realization shall discontinue that practice prospectively and shall follow the guidance in this Statement and in Statement 109.

82. Outstanding equity instruments that are measured at intrinsic value under Statement 123 at the required effective date because it was not possible to reasonably estimate their grant-date fair value shall continue to be measured at intrinsic value until they are settled.

Nonpublic Entities That Used the Minimum Value Method in Statement 123

83. Nonpublic entities, including those that become public entities after June 15, 2005, that used the minimum value method of measuring equity share options and similar instruments for either recognition or pro forma disclosure purposes under Statement 123 shall apply this Statement prospectively to new awards and to awards modified, repurchased, or cancelled after the required effective date. Those entities shall continue to account for any portion of awards outstanding at the date of initial application using the accounting principles originally applied to those awards (either the minimum value method under Statement 123 or the provisions of Opinion 25 and its related interpretive guidance).

Required Disclosures in the Period This Statement Is Adopted

84. In the period that this Statement is adopted, an entity shall disclose the effect of the change from applying the original provisions of Statement 123[38] on income from continuing operations, income before income taxes, net income, cash flow from operations, cash flow from financing activities, and basic and diluted earnings per share. In addition, if awards under share-based payment arrangements with employees are accounted for under the intrinsic value method of Opinion 25 for any reporting period for which an income statement is presented, all public entities shall continue to provide the tabular presentation of the following information that was required by paragraph 45 of Statement 123 for all those periods:

a. Net income and basic and diluted earnings per share as reported

b. The share-based employee compensation cost, net of related tax effects, included in net income as reported

c. The share-based employee compensation cost, net of related tax effects, that would have been included in net income if the fair-value-based method had been applied to all awards[39]

d. Pro forma net income as if the fair-value-based method had been applied to all awards

e. Pro forma basic and diluted earnings per share as if the fair-value-based method had been applied to all awards.

The required pro forma amounts shall reflect the difference in share-based employee compensation cost, if any, included in net income and the total cost measured by the fair-value-based method, as well as additional tax effects, if any, that would have been recognized in the income statement if the fair-value-based method

[34] A nonpublic entity shall apply this method to all prior years for which Statement 123's fair-value-based method was adopted for recognition or pro forma disclosures if that date is later than when Statement 123 was first effective.

[35] For convenience, the remaining discussion in this Statement refers only to *Statement 123*. Those references should be understood as referring to Statement 123, as amended by Statement 148.

[36] This provision applies to all awards regardless of whether they were accounted for as fixed or variable under Opinion 25.

[37] If share-based compensation cost has been previously capitalized as part of another asset, an entity should consider whether the carrying amount of that asset should be adjusted to reflect amounts calculated pursuant to paragraphs 79(a) and 79(b).

[38] The effect of the change for the period in which this Statement is adopted will differ depending on whether a public entity had previously adopted the fair-value-based method (or a nonpublic entity had adopted the minimum value method) of Statement 123 or had continued to use the intrinsic value method in Opinion 25.

[39] For paragraphs 84(c)–84(e), *all awards* refers to awards granted, modified, or settled in cash in fiscal periods beginning after December 15, 1994.

had been applied to all awards. The required pro forma per-share amounts shall reflect the change in the denominator of the diluted earnings per share calculation as if the assumed proceeds under the treasury stock method, including measured but unrecognized compensation cost and any excess tax benefits credited to additional paid-in capital, were determined under the fair-value-based method.

85. A nonpublic entity that used the minimum value method for pro forma disclosure purposes under the original provisions of Statement 123 shall not continue to provide those pro forma disclosures for outstanding awards accounted for under the intrinsic value method of Opinion 25.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
George J. Batavick
G. Michael Crooch
Gary S. Schieneman
Katherine Schipper
Leslie F. Seidman
Edward W. Trott

GLOSSARY

E1. This appendix contains definitions of certain terms or phrases used in this Statement.

Blackout period. A period of time during which exercise of an equity share option is contractually or legally prohibited.

Broker-assisted cashless exercise. The simultaneous exercise by an employee of a share option and sale of the shares through a broker (commonly referred to as a *broker-assisted exercise*).

Generally, under this method of exercise:

a. The employee authorizes the exercise of an option and the immediate sale of the option shares in the open market.

b. On the same day, the entity notifies the broker of the sale order.

c. The broker executes the sale and notifies the entity of the sales price.

d. The entity determines the minimum statutory tax-withholding requirements.

e. By the settlement day (generally three days later), the entity delivers the stock certificates to the broker.

f. On the settlement day, the broker makes payment to the entity for the exercise price and the minimum statutory withholding taxes and remits the balance of the net sales proceeds to the employee.

Calculated value. A measure of the value of a share option or similar instrument determined by substituting the historical volatility of an appropriate industry sector index for the expected volatility of a nonpublic entity's share price in an option-pricing model.

Closed-form model. A valuation model that uses an equation to produce an estimated fair value. The Black-Scholes-Merton formula is a closed-form model. In the context of option valuation, both closed-form models and lattice models are based on risk-neutral valuation and a contingent claims framework. The payoff of a contingent claim, and thus its value, depends on the value(s) of one or more other assets. The contingent claims framework is a valuation methodology that explicitly recognizes that dependency and values the contingent claim as a function of the value of the underlying asset(s). One application of that methodology is risk-neutral valuation in which the contingent claim can be replicated by a combination of the underlying asset and a risk-free bond. If that replication is possible, the value of the contingent claim can be determined without estimating the expected returns on the underlying asset. The Black-Scholes-Merton formula is a special case of that replication.

Combination award. An award with two or more separate components, each of which can be separately exercised. Each component of the award is actually a separate award, and compensation cost is measured and recognized for each component.

Cross-volatility. A measure of the relationship between the volatilities of the prices of two assets taking into account the correlation between movements in the prices of the assets. (Refer to the definition of **volatility**.)

Derived service period. A service period for an award with a market condition that is inferred from the application of certain valuation techniques used to estimate fair value. For example, the derived service period for an award of share options that the employee can exercise only if the share price increases by 25 percent at any time during a 5-year period can be inferred from certain valuation techniques. In a lattice model, that derived service period represents the duration of the median of the distribution of share price paths on which the market condition is satisfied. That median is the middle share price path (the midpoint of the distribution of paths) on which the market condition is satisfied. The duration is the period of time from the service inception date to the expected date of satisfaction (as inferred from the valuation technique). If the derived service period is three years, the estimated requisite service period is three years and all compensation cost would be recognized over that period, unless the market condition was satisfied at an earlier date.[170] Further, award of fully vested, deep out-of-the-money share options has a derived service period that must be determined from the valuation techniques used to estimate fair value. (Refer to the definitions of **explicit service period, implicit service period,** and **requisite service period.**)

Economic interest in an entity. Any type or form of pecuniary interest or arrangement that an entity could issue or be a party to, including equity securities; financial instruments with characteristics of equity, liabilities, or both; long-term debt and other debt-financing arrangements; leases; and contractual arrangements such as management contracts, service contracts, or intellectual property licenses.

Employee. An individual over whom the grantor of a share-based compensation award exercises or has the right to exercise sufficient control to establish an employer-employee relationship based on common law as illustrated in case law and currently under U.S. Internal Revenue Service Revenue Ruling 87-41.[171] Accordingly, a grantee meets the definition of an employee if the grantor consistently represents that individual to be an employee under common law. The definition of an employee for payroll tax purposes under the U.S. Internal Revenue Code includes common law employees. Accordingly, a grantor that classifies a grantee potentially subject to U.S. payroll taxes as an employee for purposes of applying this Statement also must represent that individual as an employee for payroll tax purposes (unless the grantee is a leased employee as described below). A grantee does not meet the definition of an employee for purposes of this Statement solely because the grantor represents that individual as an employee for some, but not all, purposes. For example, a requirement or decision to classify a grantee as an employee for U.S. payroll tax purposes does not, by itself, indicate that the grantee is an employee for purposes of this Statement because the grantee also must be an employee of the grantor under common law.

A leased individual is deemed to be an employee of the lessee for purposes of this Statement if all of the following requirements are met:

a. The leased individual qualifies as a common law employee of the lessee, and the lessor is contractually required to remit payroll taxes on the compensation paid to the leased individual for the services provided to the lessee.

b. The lessor and lessee agree in writing to all of the following conditions related to the leased individual:

1. The lessee has the exclusive right to grant stock compensation to the individual for the employee service to the lessee.
2. The lessee has a right to hire, fire, and control the activities of the individual. (The lessor also may have that right.)
3. The lessee has the exclusive right to determine the economic value of the services performed by the individual (including wages and the number of units and value of stock compensation granted).
4. The individual has the ability to participate in the lessee's employee benefit plans, if any, on the same basis as other comparable employees of the lessee.
5. The lessee agrees to and remits to the lessor funds sufficient to cover the complete compensation, including all payroll taxes, of the individual on or before a contractually agreed upon date or dates.

A nonemployee director does not satisfy this definition of employee. Nevertheless, for purposes of this Statement, nonemployee directors acting in their role as members of a board of directors are treated as employees if those directors were (a) elected by the employer's shareholders or (b) appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to nonem-

[170] Compensation cost would not be recognized beyond three years even if after the grant date the entity determines that it is not probable that the market condition will be satisfied within that period.

[171] A reporting entity based in a foreign jurisdiction would determine whether an employee-employer relationship exists based on the pertinent laws of that jurisdiction.

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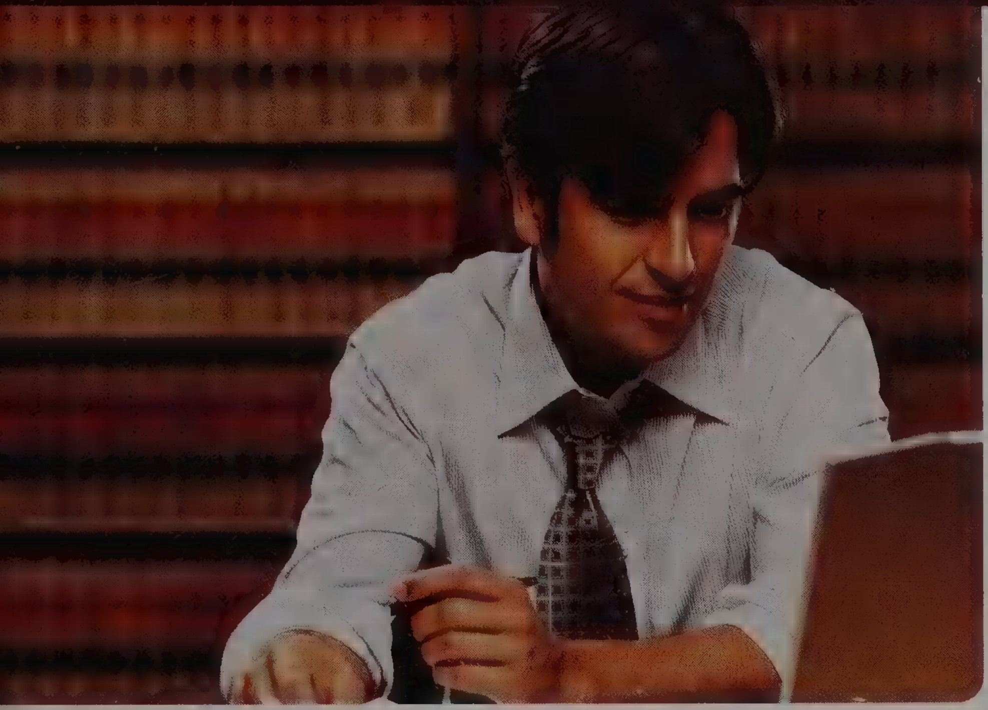

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ployee directors for their services as directors. Awards granted to those individuals for other services shall be accounted for as awards to nonemployees for purposes of this Statement.

Employee share ownership plan. An employee benefit plan that is described by the Employment Retirement Income Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.

Equity restructuring. A nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.

Excess tax benefit. The realized tax benefit related to the amount (caused by changes in the fair value of the entity's shares after the **measurement date** for financial reporting) of deductible compensation cost reported on an employer's tax return for equity instruments in excess of the compensation cost for those instruments recognized for financial reporting purposes.

Explicit service period. A service period that is explicitly stated in the terms of a share-based payment award. For example, an award stating that it vests after three years of continuous employee service from a given date (usually the grant date) has an explicit service period of three years. (Refer to **derived service period, implicit service period,** and **requisite service period.**)

Fair value. The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Freestanding financial instrument. A financial instrument that is entered into separately and apart from any of the entity's other financial instruments or equity transactions or that is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Grant date. The date at which an employer and an employee reach a mutual understanding of the key terms and conditions of a share-based payment award. The employer becomes contingently obligated on the grant date to issue equity instruments or transfer assets to an employee who renders the requisite service. Awards made under an arrangement that is subject to shareholder approval are not deemed to be granted until that approval is obtained unless approval is essentially a formality (or perfunctory), for example, if management and the members of the board of directors control enough votes to approve the arrangement. Similarly, individual awards that are subject to approval by the board of directors, management, or both are not deemed to be granted until all such approvals are obtained. The grant date for an award of equity instruments is the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares. (Refer to the definition of **service inception date.**)

Implicit service period. A service period that is not explicitly stated in the terms of a share-based payment award but that may be inferred from an analysis of those terms and other facts and circumstances. For instance, if an award of share options vests upon the completion of a new product design and it is probable that the design will be completed in 18 months, the implicit service period is 18 months. (Refer to **derived service period, explicit service period,** and **requisite service period.**)

Intrinsic value. The amount by which the fair value of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of $20 on a stock whose current market price is $25 has an intrinsic value of $5. (A nonvested share may be described as an option on that share with an exercise price of zero. Thus, the fair value of a share is the same as the intrinsic value of such an option on that share.)

Issued, issuance, or **issuing** of an equity instrument. An equity instrument is issued when the issuing entity receives the agreed-upon consideration, which may be cash, an enforceable right to receive cash or another financial instrument, goods, or services. An entity may conditionally transfer an equity instrument to another party under an arrangement that permits that party to choose at a later date or for a specified time whether to deliver the consideration or to forfeit the right to the conditionally transferred instrument with no further obligation. In that situation, the equity instrument is not issued until the issuing entity has received the consideration. For that reason, this Statement does not use the term *issued* for the grant of stock options or other equity instruments subject to vesting conditions.

Lattice model. A model that produces an estimated fair value based on the assumed changes in prices of a financial instrument over successive periods of time. The binomial model is an example of a lattice model. In each time period, the model assumes that at least two price movements are possible. The lattice represents the evolution of the value of either a financial instrument or a market variable for the purpose of valuing a financial instrument. In this context, a lattice model is based on risk-neutral valuation and a contingent claims framework. (Refer to **closed-form model** for an explanation of the terms *risk-neutral valuation* and *contingent claims framework.*)

Market condition. A condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award under a share-based payment arrangement that relates to the achievement of (a) a specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's shares or (b) a specified price of the issuer's shares in terms of a similar[172] (or index of similar) equity security (securities).

Measurement date. The date at which the equity share price and other pertinent factors, such as expected volatility, that enter into measurement of the total recognized amount of compensation cost for an award of share-based payment are fixed.

Modification. A change in any of the terms or conditions of a share-based payment award.

Nonpublic entity. Any entity other than one (a) whose equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b). An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is a nonpublic entity for purposes of this Statement.

Nonvested shares. Shares that an entity has not yet issued because the agreed-upon consideration, such as employee services, has not yet been received. Nonvested shares cannot be sold. The restriction on sale of nonvested shares is due to the forfeitability of the shares if specified events occur (or do not occur).

Performance condition. A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to both (a) an employee's rendering service for a specified (either explicitly or implicitly) period of time and (b) achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities). Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions for purposes of this Statement. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share that exceeds the average growth rate in earnings per share of other entities in the same industry is a performance condition for purposes of this Statement. A performance target might pertain either to the performance of the enterprise as a whole or to some part of the enterprise, such as a division or an individual employee.

Public entity. An entity (a) with equity securities that trade in a public market, which may be either a stock exchange (domestic or foreign) or an over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b). That is, a subsidiary of a public entity is itself a public entity. An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is not a public entity for purposes of this Statement.

Related party. An affiliate of the reporting entity; another entity for which the reporting entity's investment is accounted for by the equity method; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners and management of the entity; members of the immediate families of principal owners of the entity and its management; and other parties with which the entity may deal if one party controls or can signif-

[172] The term *similar* as used in this definition refers to an equity security of another entity that has the same type of residual rights. For example, common stock of one entity generally would be similar to the common stock of another entity for this purpose.

icantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests. This definition is the same as the definition of *related parties* in paragraph 24 of FASB Statement No. 57, *Related Party Disclosures.*

Reload feature and reload option. A reload feature provides for automatic grants of additional options whenever an employee exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price. At the time of exercise using shares, the employee is automatically granted a new option, called a reload option, for the shares used to exercise the previous option.

Replacement award. An award of share-based compensation that is granted (or offered to grant) concurrently with the cancellation of another award.

Requisite service period (and **requisite service**). The period or periods during which an employee is required to provide service in exchange for an award under a share-based payment arrangement. The service that an employee is required to render during that period is referred to as the *requisite service.* The requisite service period for an award that has only a service condition is presumed to be the vesting period, unless there is clear evidence to the contrary. If an award requires future service for vesting, the entity cannot define a prior period as the requisite service period. Requisite service periods may be explicit, implicit, or derived, depending on the terms of the share-based payment award.

Restricted share. A share for which sale is contractually or governmentally prohibited for a specified period of time. Most grants of shares to employees are better termed *nonvested shares* because the limitation on sale stems solely from the forfeitability of the shares before employees have satisfied the necessary service or performance condition(s) to earn the rights to the shares. Restricted shares issued for consideration other than employee services, on the other hand, are fully paid for immediately. For those shares, there is no period analogous to a requisite service period during which the issuer is unilaterally obligated to issue shares when the purchaser pays for those shares, but the purchaser is not obligated to buy the shares. This Statement uses the term *restricted shares* to refer only to fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.[173] (Refer to the definition of **nonvested shares.**)

Restriction. A contractual or governmental provision that prohibits sale (or substantive sale by using derivatives or other means to effectively terminate the risk of future changes in the share price) of an equity instrument for a specified period of time.

Service condition. A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that depends solely on an employee rendering service to the employer for the requisite service period. A condition that results in the acceleration of vesting in the event of an employee's death, disability, or termination without cause is a service condition.

Service inception date. The date at which the requisite service period begins. The service inception date usually is the grant date, but the service inception date may differ from the grant date (refer to Illustration 3, paragraphs A79–A85).

Settle, settled, or **settlement** of an award. An action or event that irrevocably extinguishes the issuing entity's obligation under a share-based payment award. Transactions and events that constitute settlements include (a) exercise of a share option or lapse of an option at the end of its contractual term, (b) vesting of shares, (c) forfeiture of shares or share options due to failure to satisfy a vesting condition, and (d) an entity's repurchase of instruments in exchange for assets or for fully vested and transferable equity instruments. The vesting of a share option is not a settlement as that term is used in this Statement because the entity remains obligated to issue shares upon exercise of the option.

Share option. A contract that gives the holder the right, but not the obligation, either to purchase (to call) or to sell (to put) a certain number of shares at a predetermined price for a specified period of time. Most share options granted to employees under share-based compensation arrangements are call options, but some may be put options.

Share unit. A contract under which the holder has the right to convert each unit into a specified number of shares of the issuing entity.

Share-based payment (or **compensation**) **arrangement.** An arrangement under which (a) one or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments or (b) the entity incurs liabilities to suppliers (1) in amounts based, at least in part[174], on the price of the entity's shares or other equity instruments or (2) that require or may require settlement by issuance of the entity's shares. For purposes of this Statement, the term *shares* includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. *Equity shares* refers only to shares that are accounted for as equity.

Share-based payment (or **compensation**) **transaction.** A transaction under a share-based payment arrangement, including a transaction in which an entity acquires goods or services because related parties or other holders of economic interests in that entity awards a share-based payment to an employee or other supplier of goods or services for the entity's benefit.

Short-term inducement. An offer by the entity that would result in modification or settlement of an award to which an award holder may subscribe for a limited period of time.

Small business issuer. A public entity that is an SEC registrant that files as a small business issuer under the Securities Act of 1933 or the Securities Exchange Act of 1934. At the date this Statement was issued, a *small business issuer* was defined as an entity that meets all of the following criteria:

a. It has revenues of less than $25 million.

b. It is a U.S. or Canadian issuer.

c. It is not an investment company.

d. If the entity is a majority-owned subsidiary, the parent company also is a small business issuer.

However, regardless of whether it satisfies those criteria, an entity is not a small business issuer if the aggregate market value of its outstanding securities held by nonaffiliates is $25 million or more.

The definition of a small business issuer is a matter of U.S. federal securities law and is subject to change. The effective date provisions of this Statement for a small business issuer apply only to an entity that files as a small business issuer under the related definition at that date.

Tandem award. An award with two (or more) components in which exercise of one part cancels the other(s).

Terms of a share-based payment award. The contractual provisions that determine the nature and scope of a share-based payment award. For example, the exercise price of share options is one of the terms of an award of share options. As indicated in paragraph 34 of this Statement, the written terms of a share-based payment award and its related arrangement, if any, usually provide the best evidence of its terms. However, an entity's past practice or other factors may indicate that some aspects of the substantive terms differ from the written terms. The substantive terms of a share-based payment award as those terms are mutually understood by the entity and a party (either an employee or a nonemployee) who receives the award provide the basis for determining the rights conveyed to a party and the obligations imposed on the issuer, regardless of how the award and related arrangement, if any, are structured. Also refer to paragraph 6 of this Statement.

Time value of an option. The portion of the fair value of an option that exceeds its intrinsic value. For example, a call option with an exercise price of $20 on a stock whose current market price is $25 has intrinsic value of $5. If the fair value of that option is $7, the time value of the option is $2 ($7 – $5).

Vest, Vesting, or **Vested.** To earn the rights to. A share-based payment award becomes vested at the date that the employee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions for purposes of this Statement.

For convenience and because the terms are commonly used in practice, this Statement refers to *vested* or *nonvested* options, shares, awards, and the like, as well as *vesting date.* The stated vesting provisions of an award often establish the requisite service period, and an award that has reached the end of the requisite service period is

[173] Vested equity instruments that are transferable to an employee's immediate family members or to a trust benefits only those family members are restricted if the transferred instruments retain the same prohibition on sale to third parties.

[174] The phrase *at least in part* is used because an award may be indexed to both the price of the entity's shares and something other than either the price of the entity's shares or a market, performance, or service condition.

vested. However, as indicated in the definition of *requisite service period*, the stated vesting period may differ from the requisite service period in certain circumstances. Thus, the more precise (but cumbersome) terms would be *options, shares*, or *awards for which the requisite service has been rendered* and *end of the requisite service period*.

Volatility. A measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Volatility also may be defined as a probability-weighted measure of the dispersion of returns about the mean. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period. That is the same as the standard deviation of the differences in the natural logarithms of the stock prices plus dividends, if any, over the period. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Volatility is typically expressed in annualized terms.

Ethics Interpretation

Ethics interpretations and rulings are promulgated by the executive committee of the professional ethics division to provide guidelines as to the scope and application of the rules but are not intended to limit such scope or application. Publication of an interpretation or ethics ruling in the Journal of Accountancy *constitutes notice to members. A member who departs from interpretations or rulings shall have the burden of justifying such departure in any disciplinary hearing.*

(The Professional Ethics Executive Committee has revised Ethics Interpretation 101-3, under Rule 101 [AICPA, Professional Standards, vol. 2, ET section 101.05] to clarify the applicability and intent of the interpretation and ensure its continued effectiveness in promoting independence when a member renders nonattest services to an attest client. Added text is in boldface italics; deleted text is struck through).

.05 101-3—Performance of nonattest services. Before a member or his or her firm ("member") performs nonattest services (for example, tax or consulting services) for an attest client,[4] the member should determine that the requirements described in this interpretation have been met. In cases where the requirements have not been met during the period of the professional engagement or the period covered by the financial statements, the member's independence would be impaired.

Engagements Subject to Independence Rules of Certain Regulatory Bodies

This interpretation requires compliance with independence regulations of authoritative regulatory bodies (such as the Securities and Exchange Commission [SEC], the General Accounting Office [GAO], the Department of Labor [DOL], and state boards of accountancy) where a member performs nonattest services for an attest client and is required to be independent of the client under the regulations of the applicable regulatory body. Accordingly, failure to comply with the nonattest services provisions contained in the independence rules of the applicable regulatory body that are more restrictive than the provisions of this interpretation would constitute a violation of this interpretation.

General Requirements for Performing Nonattest Services

1. The member should not perform management functions or make management decisions for the attest client. However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions.

2. The client must agree to perform the following functions in connection with the engagement to perform nonattest services:

a. Make all management decisions and perform all management functions;

b. Designate an ~~competent employee~~ ***individual who possesses suitable skill, knowledge, and/or experience***, preferably within senior management, to oversee the services;

c. Evaluate the adequacy and results of the services performed;

d. Accept responsibility for the results of the services; and

e. Establish and maintain internal controls, including monitoring ongoing activities.

The member should be satisfied that the client will be able to meet all of these criteria and make an informed judgment on the results of the member's nonattest services. In assessing ***whether*** the ~~competency of the client's~~ designated ***individual*** ~~employee~~ ***possesses suitable skill, knowledge, and/or experience***, the member should be satisfied that such individual understands the services to be performed sufficiently to oversee them. ***However, the individual is not required to possess the expertise to perform or re-perform the services.***

In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with ~~the~~ ***suitable skill, knowledge, and/or experience*** ~~necessary competence~~ to oversee the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the member's provision of these services would impair independence.

3. Before performing nonattest services, the member should establish and document in writing[5] his or her understanding with the client (board of directors, audit committee, or management, as appropriate in the circumstances) regarding the following:

a. Objectives of the engagement

b. Services to be performed

c. Client's acceptance of its responsibilities

d. Member's responsibilities

e. Any limitations of the engagement

The documentation requirement does not apply to:

~~*a.* Certain routine activities performed by the member such as providing advice and responding to the client's technical questions as part of the normal client-member relationship.~~

~~*b.*~~***a.*** Nonattest services performed prior to January 1, 2005.

~~*c.*~~***b.*** Nonattest services performed prior to the client becoming an attest client.[6]

General requirements 2 and 3 above do not apply to certain routine activities performed by the member such as providing advice and responding to the client's questions as part of the normal client-member relationship.

General Activities

The following are some general activities that would ~~be considered to~~ impair a member's independence:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents[7] in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Supervising client employees in the performance of their normal recurring activities
- Determining which recommendations of the member should be implemented
- Reporting to the board of directors on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent

Specific Examples of Nonattest Services

The examples in [the table on pages 109–110] identify the effect that performance of certain nonattest services for an attest client can have on a member's independence. These examples presume that the general requirements in the previous section "General Requirements for Performing Nonattest Services" have been met and are not intended to be all-inclusive of the types of nonattest services performed by members.

(continued on page 111)

[4] A member who performs a compilation engagement for a client should modify the compilation report to indicate a lack of independence if the member does not meet all of the conditions set out in this interpretation when providing a nonattest service to that client (see Statement on Standards for Accounting and Review Services No. 1, *Compilation and Review of Financial Statements* [AR section 100.19]).

[5] ~~An isolated and inadvertent~~ failure to prepare the required documentation would not impair independence, ***but would be considered a violation of Rule 202—Compliance with Standards***, provided that the member did establish the understanding with the client.~~, the member documents the understanding promptly upon discovery of the failure to do so, and all other provisions of the interpretation are met.~~

[6] However, upon the acceptance of an attest engagement, the member should prepare written documentation demonstrating his or her compliance with the other general requirements during the period covered by the financial statements, including the requirement to establish an understanding with the client.

[7] Source documents are the documents upon which evidence of an accounting transaction are initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders.

Impact on Independence of Performance of Nonattest Services

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Bookkeeping	■ Record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client's general ledger. ■ Prepare financial statements based on information in the trial balance. ■ Post client-approved entries to a client's trial balance. ■ Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.	■ Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval. ■ Authorize or approve transactions. ■ Prepare source documents. ■ Make changes to source documents without client approval.
Payroll and other disbursement	■ Using payroll time records provided and approved by the client, generate unsigned checks, or process client's payroll. ■ Transmit client-approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information. ■ Make electronic payroll tax payments in accordance with U.S. Treasury Department or comparable guidelines provided the client has made arrangements for its financial institution to limit such payments to a named payee.[8]	■ Accept responsibility to authorize payment of client funds, electronically or otherwise, except as specifically provided for with respect to electronic payroll tax payments. ■ Accept responsibility to sign or cosign client checks, even if only in emergency situations. ■ Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client. ■ Sign payroll tax return on behalf of client management. ■ Approve vendor invoices for payment
Benefit plan administration[9]	■ Communicate summary plan data to plan trustee. ■ Advise client management regarding the application or impact of provisions of the plan document. ■ Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member's electronic medium, such as an interactive voice response system or Internet connection or other media. ■ Prepare account valuations for plan participants using data collected through the member's electronic or other media. ■ Prepare and transmit participant statements to plan participants based on data collected through the member's electronic or other medium.	■ Make policy decisions on behalf of client management. ■ When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management's concurrence. ■ Make disbursements on behalf of the plan. ■ Have custody of assets of a plan. ■ Serve a plan as a fiduciary as defined by ERISA.

(continued on page 110)

[8] Although this type of transaction may be considered by some to be similar to signing checks or disbursing funds, the Professional Ethics Executive Committee concluded that making electronic payroll tax payments under the specified criteria would not impair a member's independence.
[9] When auditing plans subject to the Employee Retirement Income Security Act (ERISA), Department of Labor (DOL) regulations, which may be more restrictive, must be followed.

Impact on Independence of Performance of Nonattest Services (continued)

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Investment—advisory or management	■ Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client's desired rate of return, risk tolerance, etc. ■ Perform recordkeeping and reporting of client's portfolio balances including providing a comparative analysis of the client's investments to third-party benchmarks. ■ Review the manner in which a client's portfolio is being managed by investment account managers, including determining whether the managers are (1) following the guidelines of the client's investment policy statement; (2) meeting the client's investment objectives; and (3) conforming to the client's stated investment styles. ■ Transmit a client's investment selection to a broker-dealer or equivalent provided the client has authorized the broker-dealer or equivalent to execute the transaction.	■ Make investment decisions on behalf of client management or otherwise have discretionary authority over a client's investments. ■ Execute a transaction to buy or sell a client's investment. ■ Have custody of client assets, such as taking temporary possession of securities purchased by a client.
Corporate finance—consulting or advisory	■ Assist in developing corporate strategies. ■ Assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria. ■ Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers, or capital sources. ■ Assist in drafting an offering document or memorandum. ■ Participate in transaction negotiations in an advisory capacity. ■ Be named as a financial adviser in a client's private placement memoranda or offering documents.	■ Commit the client to the terms of a transaction or consummate a transaction on behalf of the client. ■ Act as a promoter, underwriter, broker-dealer, or guarantor of client securities, or distributor of private placement memoranda or offering documents. ■ Maintain custody of client securities.
Executive or employee search	■ Recommend a position description or candidate specifications. ■ Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g., required skills and experience). ■ Participate in employee hiring or compensation discussions in an advisory capacity.	■ Commit the client to employee compensation or benefit arrangements. ■ Hire or terminate client employees.
Business risk consulting	■ Provide assistance in assessing the client's business risks and control processes. ■ Recommend a plan for making improvements to a client's control processes and assist in implementing these improvements.	■ Make or approve business risk decisions. ■ Present business risk considerations to the board or others on behalf of management.
Information systems—design, installation or integration	■ Install or integrate a client's financial information system, that was not designed or developed by the member (e.g., an off-the-shelf accounting package). ■ Assist in setting up the client's chart of accounts and financial statement format with respect to the client's financial information system. ■ Design, develop, install, or integrate a client's information system that is unrelated to the client's financial statements or accounting records. ■ Provide training and instruction to client employees on an information and control system.	■ Design or develop a client's financial information system. ■ Make other than insignificant modifications to source code underlying a client's existing financial information system. ■ Supervise client personnel in the daily operation of a client's information system. ■ Operate a client's local area network (LAN) system.

Appraisal, Valuation, and Actuarial Services
Independence would be impaired if a member performs an appraisal, valuation, or actuarial service for an attest client where the results of the service, individually or in the aggregate, would be material to the financial statements and the appraisal, valuation, or actuarial service involves a significant degree of subjectivity.

Valuations performed in connection with, for example, employee stock ownership plans, business combinations, or appraisals of assets or liabilities generally involve a significant degree of subjectivity. Accordingly, if these services produce results that are material to the financial statements, independence would be impaired.

An actuarial valuation of a client's pension or postemployment benefit liabilities generally produces reasonably consistent results because the valuation does not require a significant degree of subjectivity. Therefore, such services would not impair independence. In addition, appraisal, valuation, and actuarial services performed for nonfinancial statement purposes would not impair independence.[10] However, in performing such services, all other requirements of this interpretation should be met, including that all significant assumptions and matters of judgment are determined or approved by the client and the client is in a position to have an informed judgment on, and accepts responsibility for, the results of the service.

[10] Examples of such services may include appraisal, valuation, and actuarial services performed for tax planning or tax compliance, estate and gift taxation, and divorce proceedings.

Internal Audit Assistance Services
Internal audit services involve assisting the client in the performance of its internal audit activities, sometimes referred to as "internal audit outsourcing." In evaluating whether independence would be impaired with respect to an attest client, the nature of the service needs to be considered.

Assisting the client in performing financial and operational[11] internal audit activities would impair independence unless the member takes appropriate steps to ensure that the client understands its responsibility for establishing and maintaining the internal control system[12] and directing the internal audit function, including the management thereof. Accordingly, any outsourcing of the internal audit function to the member whereby the member in effect manages the internal audit activities of the client would impair independence.

[11] For example, a member may assess whether performance is in compliance with management's policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision making.

[12] As part of its responsibility to establish and maintain internal control, management monitors internal control to assess the quality of its performance over time. Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of both. Ongoing monitoring activities are the procedures designed to assess the quality of internal control performance over time and built into the normal recurring activities of an entity; they include regular management and supervisory activities, comparisons, reconciliations, and other routine actions. Separate evaluations focus on the continued effectiveness of a client's internal control. A member's independence would not be impaired by the performance of separate evaluations of the effectiveness of a client's internal control, including separate evaluations of the client's ongoing monitoring activities.

In addition to the general requirements of this interpretation, the member should ensure that client management:

- Designates a*n* ~~competent~~[13] individual or individuals, ***who possess suitable skill, knowledge, and/or experience***, preferably within senior management, to be responsible for the internal audit function;
- Determines the scope, risk, and frequency of internal audit activities, including those to be performed by the member providing internal audit assistance services;
- Evaluates the findings and results arising from the internal audit activities, including those performed by the member providing internal audit assistance services; and
- Evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by,

[13] ~~A competent individual would have an understanding of internal audit activities sufficient to oversee the services performed by the member. [Footnote added, effective December 31, 2003, by the Professional Ethics Executive Committee.]~~

among other things, obtaining reports from the member.

The member should also be satisfied that the client's board of directors, audit committee, or other governing body is informed about the member's and management's respective roles and responsibilities in connection with the engagement. Such information should provide the client's governing body a basis for developing guidelines for management and the member to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.

The member is responsible for performing the internal audit procedures in accordance with the terms of the engagement and reporting thereon. The performance of such procedures should be directed, reviewed, and supervised by the member. The report should include information that allows the individual responsible for the internal audit function to evaluate the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures.

This report may include recommendations for improvements in systems, processes, and procedures. The member may assist the individual responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. However, the member should not undertake any responsibilities that are required, as described above, to be performed by the individual responsible for the internal audit function.

The following are examples of activities (in addition to those listed in the "General Activities" section of this interpretation) that, if performed as part of an internal audit assistance engagement, would impair independence:

- Performing ongoing monitoring activities or control activities (for example, reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function
- Determining which, if any, recommendations for improving the internal control system should be implemented
- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function
- Approving or being responsible for the overall internal audit work plan including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures
- Being connected with the client as an employee or in any capacity equivalent to a member of client management (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications)

The foregoing list is not intended to be all-inclusive.

Services involving an extension of the procedures that are generally of the type considered to be extensions of the member's audit scope applied in the audit of the client's financial statements, such as confirming of accounts receivable and analyzing fluctuations in account balances, are not considered internal audit assistance services and would not impair independence even if the extent of such testing exceeds that required by generally accepted auditing standards. In addition, engagements performed under the attestation standards would not be considered internal audit assistance services and therefore would not impair independence.

Transition

Independence would not be impaired as a result of the more restrictive requirements of interpretation 101-3, provided the provision of any such nonattest services are pursuant to arrangements in existence on December 31, 2003, and are completed by December 31, 2004, and the member was in compliance with the preexisting requirements of this interpretation. ■

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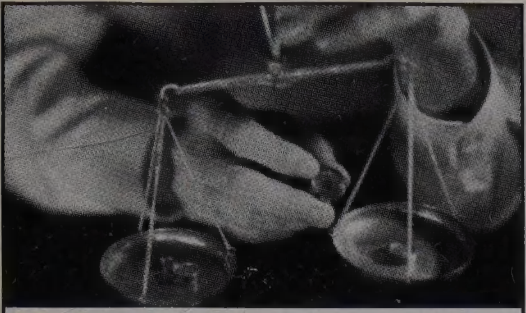

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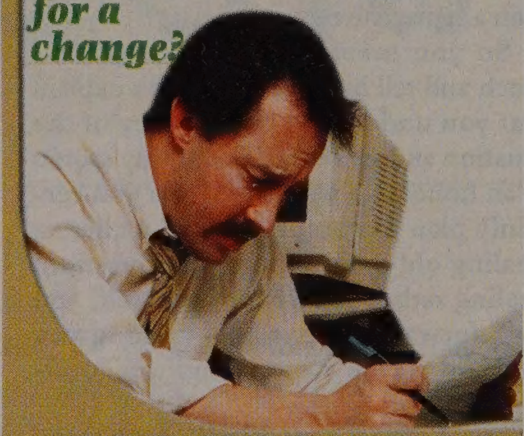

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BY STANLEY ZAROWIN

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It's a job offer you can't refuse—a major step up the management ladder and a big boost in pay. Accepting the offer was easy; the hard part is telling your current boss and colleagues that you're leaving to go to a major competitor. You want to handle your resignation gracefully and leave without feeling you're deserting them, taking company secrets with you or planning to steal their clients. After all, you not only respect your boss and many of your colleagues, you consider them close personal friends. Because of that, as a way to show your loyalty, you plan to offer to stay on for at least a month to clear up loose ends and help find and train a replacement.

So you meet with your boss over lunch and tell him the news. You explain that you understand the delicacy of the situation and will handle company secrets in an honorable way, that while you certainly plan to compete for new clients, stealing old ones is out of the question. Feeling rather good about yourself, you look forward to your boss wishing you well and maybe even arranging a goodbye party.

Think again. To your surprise he suggests you clean out your desk immediately and orders security to escort you out the door that afternoon. Worse, he makes it clear you won't be getting the yearend bonus you expected next week.

What went wrong? Plenty.

First of all, don't underestimate the reaction you'll get if you move to a competitor. Your boss has the responsibility to envision the worst: not only that you might share company secrets with your new employer and steal customers, but even that you might sink so low as to try to lure colleagues to join you. And for that you expect a party?

You're lucky he didn't hit you with a noncompete lawsuit. Which brings up another sensitive issue: If you did indeed sign such an agreement, you should have spoken to your lawyer before accepting the new job and certainly before making your move public. Depending on how tightly the agreement is written, you may have no choice but to turn down that job.

If your new employer is not a competitor, you may get that party and wishes of good luck. But don't count on it. Owners of small companies often identify longtime employees as family and interpret a resignation as a "divorce."

How should you handle the period between your announced resignation and your exit? If the company has been fair to you, don't spend it playing solitaire at your desk. Prepare detailed memos for your replacement listing the status of incomplete work and things that need to be done. If asked, help train a replacement.

At the exit interview, resist bringing up old complaints or identifying those you view as incompetent. It's best to be diplomatic; after all, you never know whether you'll want, or need, to return, or to ask your old boss for a recommendation if the new job doesn't work out.

Of course, if your company regularly awards bonuses at fixed times of the year, don't announce your resignation until after the check clears.

In other words, expect the best, but prepare for the worst.

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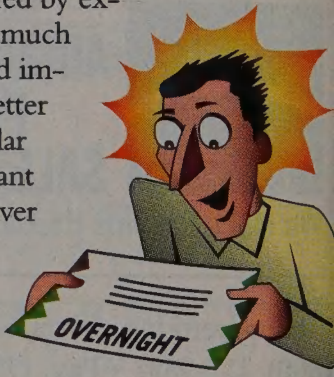

STANLEY ZAROWIN, a former *JofA* senior editor, is now a contributing editor to the magazine. His e-mail address is zarowin@mindspring.com.

An Invitation

The JofA publishes a monthly collection of Golden Business Ideas and invites readers to contribute their favorites (for attribution, if you like).

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